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THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

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The Canadian Chartered Accountant

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By The Dominion Association of Chartered Accountants

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COMMENT AND OPINION

A Tribute

THE recent fine imposed on The Journal Publishing Co. of Ottawa for a published news report which might have affected the course of a jury trial has received considerable attention in newspapers and there is no doubt that the accompanying admonition given by Chief Justice McRuer will be in the minds of editors for a long time.

What has impressed us particularly in this incident has been the dignity and forthrightness with which all involved handled themselves. So far as the Chief Justice is concerned, the high standard of the judicial approach to a problem is expected and the expectation has been realized. The attitude of the defendants could, however, have taken several courses and it is the course that was taken which results in this note.

Whether or not it is true, we do not know, but it seems to us that during the last 20 years a growing tendency has developed to make excuses, to find (after the event) reasons for actions taken and to endeavour to explain them away as being of no account. It is refreshing, therefore, to find in this instance an unequivocal apology expressed on behalf of *The Journal* by Mr. Grattan O'Leary, one of its senior officers and editors. Further, while it had been suggested that *The Journal* should have had the benefit of counsel during the appearance of its representatives, this was deemed unnecessary by the company.

Mr. O'Leary's statement to the Court has not been given the reproduction in the press to the extent which we consider it deserves and it is quoted here in full (as it appeared in *The Toronto Daily Star* of February 14, 1951),—

> *His Lordship*: Now, Mr. O'Leary, have you anything you want to say in connection with this matter, this very serious matter?
>
> *Mr. O'Leary*: With your permission, my lord, I should like to say merely that I have come here not to argue the merits or the demerits of the item complained of, but to express to you and to this Court our extreme regret, without reservations and without qualifications. We are a newspaper, my lord, which, as we have said in our letter to the sheriff, has tried to uphold at all times the integrity, the authority and the prestige of His Majesty's Courts of Justice and of those who interpret our laws.
>
> I do not say that in mitigation of our position here today. Our reporters who wrote the item complained of have not been asked by us for the source of their information, because we have, rightly or wrongly, regarded that as a proper rule of conduct in a newspaper office; but I can say to your lordship they have assured us that, as we state in our letter, they had no intention of being in contempt of court and no knowledge that they were in contempt of court. As for the editors of the paper themselves, for whom I speak, I can only repeat again that we have preached time and again that cases before Courts must be tried in the Courts and not in the newspapers, as regrettably has happened in some lands.

So, your lordship, I repeat that we have come here, and are glad to come here; in fact, being the newspaper that we are, we are proud to come here publicly to proclaim that we regret, and apologize without any qualifications whatsoever, for the item which is complained of. Thank you, my lord.

Canadians have the highest regard for Mr. O'Leary, developed from his writings and speeches over many years, and he will find that this case will in no way diminish the respect in which he is held.

We have had before us for some months a statement entitled "Freedom of the Press" prepared by the Canadian Daily Newspapers Association. The following quotation causes us to speculate on the authorship of the statement. Could it have been Mr. O'Leary?

The only truly free press is one which can record the news faithfully and comment on it frankly, without fear of direct or indirect punishment. Neither the press nor the public is safe with anything less than this.

All liberty, of course, involves obligations. The obligation of a free press is to be truly free. It must be thorough, accurate and unbiased in its reporting, sincere and thoughtful in its editorials, and resistant to all outside pressure. It must be both cautious and bold — cautious until it knows all the facts, bold when it is sure of its ground. It must, above all, be inspired by devotion to the public welfare as its staff understands it.

Mr. O'Leary's words in Court are entirely consistent with these principles.

CHANGE OF NAME !

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

A Bill to change the name of the Dominion Association of Chartered Accountants to The Canadian Institute of Chartered Accountants has passed both Houses of Parliament, and at the time of going to press with this issue was awaiting the assent of the Governor-General, which is expected shortly. The Bill reads as follows:

AN ACT RESPECTING

THE DOMINION ASSOCIATION OF CHARTERED ACCOUNTANTS

WHEREAS The Dominion Association of Chartered Accountants, a corporation incorporated by chapter fifty-eight of the statutes of 1902, has by its petition prayed that it be enacted as hereinafter set forth, and it is expedient to grant the prayer of the petition: Therefore His Majesty, by and with the advice and consent of the Senate and House of Commons of Canada, enacts as follows:—

I. Name changed, — Existing rights not affected. — The name of "The Dominion Association of Chartered Accountants" hereinafter called "the Association", is hereby changed to "The Canadian Institute of Chartered Accountants", but such change in name shall not in any way impair, alter or affect the rights or liabilities of the Association or any bequest, gift or donation now made or which hereafter may be made to the Association whether by its original or its new name or any suit or proceeding now pending or judgment existing either by or in favour of or against the Association and which, notwithstanding such change in name of the Association, may be enforced and continued as if this Act had not been passed.

The Influence of Reports On Top Management Decisions

By C. E. Jarchow, C.P.A.

Occasionally business management acts on hunches, but much more often decisions are based on factual information

REPORTS can be of great benefit to business. They can also be a great burden. Generally speaking, I am not in favour of the making of more reports, or the designing of new types or more complicated reports. Rather I am an advocate of fewer but better reports, the kind which are most useful to management.

Utility of Reports

Reports once started have a habit of perpetuating themselves unless re-examined periodically in the light of their current usefulness. As a result, many companies today are weighted down with such a mass of regular reports that it is impossible to digest their contents. A report which does not serve a worthwhile purpose should be discontinued.

Not all reports can be considered to come within the category of reports designed to influence managerial decisions or policy-making. For example, there are reports requested by government agencies and reports required by law. There are reports which serve an important historical purpose in perpetuating and making available for future use important statistical data pertaining to the business. There are also reports which merely show the tempo of business activity, such as those which show current performance, (e.g. production or sales statistics). Such reports are like the gauges in a powerhouse, or like the instruments on the dashboard of your car. Reports of this type, although informative and important, are not designed or intended primarily to influence managerial decisions.

On the other hand, there are a great many reports, both of a regular and of a special nature, which are designed to influence managerial decisions. Included in this category are those which show the accomplishments of the business enterprise such as cost analyses, profit and loss statements, changes in financial position, comparisons of actual results with forecasts, and so on.

Important also are reports issued for a special purpose, such as investigations of a particular phase of business. Internal audits of the managerial type come within this category. Also reports showing the probable results under two or more possible courses of action. Since these latter reports relate to possible future activities, they are generally in

An address to the Toronto Control of the Controllers Institute of America, Feb. 13, 1951.

the realm of forecasts and estimates. Reports of this kind, properly prepared and tempered by experience and good judgment, can be extremely important to business management.

In the operation of any business a great many decisions must be made from day to day. Many of them have a direct influence on the cost of doing business and on the profitableness of the business activity. These decisions are sometimes concerned with long-range problems and sometimes they deal with routine or day by day situations. Whether of a long-range or of a routine character, the problems which present themselves for decisions may in most cases be illuminated and clarified by a presentation of facts and figures pertaining thereto. Occasionally, of course, business management may act on hunches; much more often, however, decisions are based upon factual information.

Basic Rules Which Apply to All Reports

Let us now consider a few basic rules which apply to all reports:

(1) In the first place, reports should be furnished promptly. While this refers particularly to regularly scheduled reports, it can also be an important point in connection with special statements which are required by management. Accounting reports almost always decrease in value in direct proportion to the length of time it takes to compile and present them.

(2) It is not always necessary that accounting reports be 100% accurate, particularly if this unduly delays the submission of the report. Of course, we should not mislead anyone through having our facts wrong, but neither should we sacrifice promptness in reporting in order to gain greater accuracy in unimportant details. In this connection approximate figures, if available soon after the conclusion of a period, may be much more valuable to management than a report mathematically correct prepared 30 days later. Many companies adopt the policy of issuing preliminary reports, which are sometimes called "flash" reports, in order to make certain that management is informed at the very earliest time of an approximate result.

(3) Reports should be stated in as simple terms as possible. A report may be prepared in accordance with good accounting theory, or may be statistically correct and yet fail in its purpose because it is unintelligible to management. The reason for this may lie in the use of too many technical or ambiguous terms, or in the failure to properly summarize the data and point up the conclusions to be drawn from the report.

(4) Reports should be basically prophetic in nature rather than merely historic. With regard to most special reports this is self-evident inasmuch as the purpose of such reports is to point the way toward a decision which should be taken. In connection with periodic reports of performance in various fields, even though their purpose is primarily to show what has happened, there is a possibility of placing the emphasis on trends or on departures from normal or standard performance. While it is important for management to know the past accomplishments of the company, and in a sense to know where the company has been, it is much more important to know where the company is going, the direction of its course, and the influence of important trends.

(5) In reporting the results of special investigations, the conclusions will inevitably be limited by the assumptions made. Wherever such assumptions are basic and important, they should be set out clearly in the report so that it may not be misleading.

(6) It is, of course, important that re-

ports be comprehensive and complete. This means that all pertinent factors must have been considered in assembling the data. This does not mean that reports should contain a lot of unessential detail. Obviously the amount of detail submitted should only be that required for correct understanding of the report.

(7) In all of our reporting we should strive to be as objective as possible. The accountant should show an unbiased viewpoint both in the assembly of the data and in the interpretations and conclusions which are pertinent to the report.

(8) One final observation — it should be borne in mind that reports of themselves do not correct inefficiencies or abuses. It still takes managerial action, and unless a report stimulates managerial action, it is as useless as a blank piece of paper. To be useful a report must tell the story clearly and simply, and must be properly interpreted.

Areas of Managerial Decision

Before considering some examples of reports which have influenced managerial decisions, we might take a look at some of the areas in which managerial decisions have to be taken.

Financial

Let us first consider the financial field, where a basic problem is that of the establishment of the capital needs of an enterprise. This involves such questions as the policy to be followed in extending credits to customers, the inventory objectives, the policy with regard to dividends, etc. Once the needs of the company have been established, it is important to determine how much capital should be supplied by retained earnings, how much by equity financing as a permanent feature of the company's capitalization, and how much should be borrowed on either short or long term to be repaid out of future earnings.

Mr. Christian E. Jarchow, C.P.A. joined the International Harvester Company in 1914 and is now vice-president and comptroller of that firm. In 1947 he was also elected a member of its Board of Directors. He has been national president and chairman of the Board of Directors of the Controllers Institute of America. He is now on the Advisory Committee of the University of Illinois and is president of the Board of Education of New Trier Township High School, Winnetka, Ill. He is a member of the Illinois Society of Certified Public Accountants.

Production

In the field of production there are a number of important problems which come up for decision. Of first importance in this connection from a long-range standpoint is the problem of plant location with its closely related questions of wage differentials and their expected permanence, freight differentials, utility service costs, etc. Another important long-range problem concerns the degree of integration desired in the production facilities of the company, i.e., how much of the product is to be made from the basic raw material, how much in semi-finished form, and how much to buy as component parts. How extensively to mechanize the production facilities is another important problem to be resolved, as well as the choice between alternative types of production equipment, material-handling equipment, etc. There is also the problem of assigning the production processes between plants — whether to make each plant more or less self-sufficient or whether to use certain plants as collateral producers of semi-finished products to be shipped to finishing plants. The working schedule of production facilities presents recurring problems as to when multiple-shift operation is desir-

able and whether a five or six day per week operation is to be preferred. The determination of quantities of the product to be made in relation to capacity is also an important problem. Consideration must also be given to the policy with respect to the replacement of equipment of various types. All of these problems in the field of production are further complicated today by the national defence programme.

Periodically questions will arise as to whether expansion of facilities is justified by a developing business. In other cases the question will be whether or not a relatively unprofitable facility should be sold or abandoned.

Engineering

In the field of engineering important problems present themselves such as when to add new products, when to discontinue old products, and when to change models. Another question which is always important from an engineering standpoint is how much quality to put into the product with due consideration of the purpose for which it is sold. Another is the extent to which common parts, or parts using common production equipment, should be designed for the various models in the line. The management must also study the degree of compromise necessary from an engineering standpoint in order to secure the maximum use of available plant facilities.

Distribution

In the distribution field the important questions are what distribution areas are to be served and what distribution channels are to be used in marketing the company's products. The matter of product-pricing is, of course, of extreme and constant significance both for prices at which the product should be sold to the ultimate users, the proper allowance to be made for dealers' and distributors' commissions, whether cash or volume discounts should be allowed, and on what scale. The service policies of many companies involve problems such as the length of time a company should be prepared to furnish service parts, and such as the correction of field complaints on its products. Another problem is the extent to which a company should go in conducting research in the field of customers' needs with regard to its products.

Industrial Relations

In the field of industrial relations, problems involved in determining the kinds of welfare plans and pension plans to adopt are of extreme importance. The fact that such plans can no longer be designed, installed, or amended unilaterally enhances the need for accuracy and speed in the preparation of reports to management on this important subject during the periods of labour negotiations. In deciding upon a pension plan, for example, the first decision is generally as to the basis on which the pensions are to be determined. The next consideration is the cost, that is, whether the company can afford the plan as originally conceived. Depending upon the cost, the basis for benefits may have to be reconsidered and changed. The next determination has to do with what method to adopt for meeting the cost of the plan. Should it be on a cash disbursement basis or a funding basis, and if the latter, should it provide for an employee only at the time of his retirement? Or should it fund for the future service cost plus interest on the past service cost, thereby preventing the past service cost from increasing, or fund the future service cost, and in addition fund the past service cost over a definite amortization period? The problem is essentially one of reconciling the demands of unions with the willingness of management, the latter being influenced of course

by the company's financial situation and by tax considerations. I think it is obvious that accounting reports prepared with the help of trained actuaries are indispensable to management in considering this type of problem.

The above summation is of course not a complete one. You can no doubt think of other important areas of decision for management which need to be considered as susceptible of clarification through accounting reports. But I think this will be sufficiently inclusive to serve as a sort of background for the examples which I am going to give.

Examples of Reports Which Influence Management

Now let us consider a few examples of reports which influence managerial decisions. In this I shall draw largely from Harvester Company experience. First, I should like to say something about audit reports. Intrinsically there is no difference between the managerial type of audit report and any other special reporting of the accounting department — except perhaps in the matter of where the initiative comes from. Many special reports are made at the specific request of management. On the other hand, the internal audit department usually has the duty — on its own initiative — to dig into any situation which seems to show possibilities of improvement and to report on it after due investigation.

The internal auditor can make an important contribution to management by making on-the-spot observations of local conditions and situations, and by furnishing reports thereupon which assist the management in modifying, clarifying, or formulating policies which are deemed necessary or desirable. As one example of this sort of information, our internal auditors recently uncovered a difference in policies at several works in the removal of foundry waste. Certain plants were using trucks for this purpose, others were making use of railroad cars. The investigation was pointed toward working out what would be the most economical method for each works involved in view of the local conditions prevailing, and as a result the method in use in certain plants was changed.

Special Investigations

Sometimes the internal audit department is requested by the management to make special investigations. Our internal audit department was requested some months ago to make a special study of the facilities of the Harvester Print Shop. This unit has been owned and operated by the company for many years and has supplied a large part of our requirements for printed matter, although they were not equipped to do some of the offset work which has been required in increasing volume in recent years. The purpose of the investigation was to establish whether we would be justified in equipping to take on a part of the company's printing requirements in this field. Actually the study had to be a good deal broader than that because of the relationship between existing and proposed facilities and because of the desirability of bringing out for the attention of the management just what the accomplishments of this print shop had been over the years. Consequently, a very complete study was made of all the aspects of this operation. As a result of this study a decision has been taken to spend a substantial sum of money to expand the scope of our print shop operations.

We have had many problems in recent years requiring decision of top management which involved large sums of money for additions to, or changes in, plant facilities. The question of new facilities for additional production in-

volves consideration of the stability or expected duration of the demand for the new product, the price at which it can be sold, the effect on other company products and on existing manufacturing facilities, the proper location of new plants, the financing of new projects, etc. Preceding the accounting department studies in these cases there must be market surveys, wage surveys, and studies by the engineering, manufacturing, treasury and other departments of the company.

An Instance

The Harvester Company management, recognizing the complexity of problems of this character which it faced in the immediate post-war period, set up a special group, which was known as the New Plants Committee, to study these problems. This group consisted of representatives from the manufacturing, accounting, and supply and inventory departments. As the occasion required, it was augmented by representatives from the industrial engineering and construction, treasury, consumer relations and labour relations departments. Meetings were held from time to time to discuss the various projects and to outline the requirements for informational data considered necessary in arriving at decisions. Reports were presented to the New Plants Committee and after full consideration a recommendation was made to top management.

In one typical case, that of the construction of a farm implement plant at Memphis, Tennessee, the final report included a covering letter signed by the general manager of the Farm Implement Division supplemented by a report from the comptroller of that division containing the following sections:

1. The necessity for an additional plant. Under this point it was brought out that the new plant was advocated primarily to replace an obsolete and inadequate plant of the division which had been sold, and secondarily to provide a better point of manufacture and distribution for two new products, the cotton picker and the hay baler.

2. A listing of the machines to be made at Memphis works, together with estimated normal requirements for these machines in future years, and the plants from which they were to be transferred.

3. A general section containing a description of the proposed new plant facilities and the building areas required for the major sections of the plant.

4. The manpower requirements of the new plant.

5. The capital outlay required for plant and equipment.

6. The total investment for manufacture at Memphis including the requirements for inventories and other working capital.

7. A statement of the estimated annual proceeds from the sale of the products to be made in this plant, and the estimated manufacturing cost and gross profit.

8. A statement of the estimated return on investment, after considering administrative expenses, income taxes, etc., and of the rate of return on sales and the turnover of sales to investment.

9. A statement of the bases used in the estimating of manufacturing costs in the new plants. In this section the assumptions which had been made as to labour rates, freight rates, utility costs, real estate taxes, and other burden items were described.

10. A statement of recommended prices from the sale of Memphis works products compared with the prices of similar machines sold by principal competitors.

11. A special section indicating what the results would be from the new plant operation on the assumption that one of the new machines would not be produced there. The purpose of this was to indicate to the management the effect on over-all results of that particular product.

In addition to the above sections, supplementary data were appended showing details of plant investment, manufacturing costs of certain typical machines, and

divisional profit on each of the products.

Of course the report, as I have just described it, was the final presentation made to the Committee after many changes had been made in the planning based on preliminary reports and after much discussion with the Committee and consideration of their recommendations. Based on this final report, the New Plants Committee recommended the favourable consideration of management for this proposal and in due course this new plant was built. It is now serving as a very important unit of the company's manufacturing facilities and the actual results of operations compare very favourably with the preliminary estimates which were submitted when the recommendation was made.

Another Case

Let us take another case which was a proposal to rearrange and expand a large implement plant. This plant had for some years been in a precarious profit position which was due in some measure to the fact that the plant was originally established as an assembly unit to produce machines of a complex nature in comparatively small quantities, and our manufacturing programme had changed over the years to a smaller machine with much larger quantities involved. In short, the problem was that the equipment in the plant and the arrangement of the departments were not suited to the existing manufacturing programme. As a result costs were higher than they should have been and the prices on these machines were too high to enable us to gain our fair share of the available market.

Following certain studies by our sales department, which indicated that there would be a sizeable increase in demand if prices could be lowered sufficiently through increased output, a study was made as to how much it would cost to rearrange and expand the plant to get out a larger production at a lower cost. This study involved practically every department of the plant. The proposal was judged from the standpoint of the return to be derived from the increased investment.

The result of the study was that the management agreed to spend about $4,000,000 on this plant. Two new buildings were provided and sufficient additional equipment to enable an increase in production amounting to approximately 60%. The number of employees was increased from 2,800 to about 4,000. As a consequence, this plant was put in a greatly improved profit position and the rate of return on the additional investment required for the rearrangement and improvement programme was very satisfactory.

Forecasting

Let us now consider an example of a report which comes under the category of regular reports and which influences managerial decisions throughout the year. It has to do with forecasted results of operations based on sales estimates, budgets, etc. While our procedure varies in different divisions, a typical practice is to make calculations prior to the beginning of each fiscal year to determine the following:

(1) The total profit objective based on a predetermined percentage of net worth;

(2) A realistic sales estimate in detail;

(3) Manufacturing costs by product lines based on the sales estimate;

(4) The amount of selling and administrative expense;

(5) The estimated trading profit by product lines;

(6) A comparison of the estimated trading profit with the profit objective. This comparison reveals whether or not the estimated volume for the ensuing year will secure the management's total expected return on investment. It also reveals the

lines which do or do not produce their pro rata share of the division's profit objective.

I shall not go into detail as to just how these steps are carried out. Being calculated in advance, they permit studies to be made as to whether certain policies should be changed in order to bring the indicated results in line with the profit objective. This profit objective approach in effect places all managerial people in the division (from shop foremen on up) in the position of being in business for themselves. It furnishes them with a guide as to the costs and expenses which each must realize if they are to run that business on a satisfactory basis. If everyone attains his goal, the overall objective for the division will be attained. If the overall results are not realized it can easily be ascertained where the failures have occurred and what should be done to overcome them.

Another important field in which regular reports by the accounting department influence managerial decisions that immediately affect the company's profit position is that of costs submitted for consideration in connection with price policy. We have a price and contract department which acts as a clearing house for the accumulation of cost and pricing data and which submits to the management from time to time, as the occasion requires, recommendations for price changes. This price and contract department receives from all of our plants regular information as to product costs and while many factors in addition to that of costs must be taken into consideration in establishing prices, this information is indispensable to the operation of this department.

Set Out Assumptions

I mentioned before that in any reporting, it is extremely important to set out the assumptions upon which the report is based. I would like to give you one important example of that. Most companies which are presently attempting to forecast 1951 profit possibilities are faced by uncertainty due to the presence of a war economy. Sales forecasts of regular products may indicate a demand that would employ productive facilities to a maximum degree. However, none of us can overlook the fact that with large defence contracts in prospect, many critical materials are going to be needed for their fulfilment, and so will not be available for normal production.

It probably is difficult in Canadian business, as it is in American, to determine to what extent this factor may prevent the full usage of productive facilities for normal business. In our case, in looking ahead for 1951, we are estimating our results on two different bases as follows: (1) on the basis of our estimates originating from the sales field, and (2) on that same basis minus a 25% factor representing possible losses in production due to inability to obtain materials. Obviously this 25% factor is an extremely arbitrary one. However, we believe that if we furnish our estimates on these two bases and set forth clearly our assumptions, it will give our management something to tie to and will show the important effect which a 25% variation will have. Similar calculations can, of course, be made based on other variations. As a matter of fact each of our divisions makes such calculations and also determines the approximate break-even points.

Consider All Factors

I previously emphasized the importance of making certain that all pertinent factors have been considered before our reports are released. Consider, for example, the following instance where we were trying to make up our minds whether to contract for certain maintenance work or to use our own facilities. At our steel mill in South Chicago, we have 11 open-

hearth steel furnaces. An open-hearth furnace requires rebuilding about every seven months. The time required for such rebuilding is approximately two weeks at a cost which may run as high as $150,000. The problem was to decide if it were more economical to use the plant bricklayers and maintenance men or to employ an outside contractor. Analysis of the cost of rebuilding indicated that it was more expensive if outside contractor help was utilized. However, further analysis indicated that due to scheduling difficulties encountered by our mason department in servicing the entire plant, three less days were necessary for the rebuilding by the outside contractor. Therefore, by reducing the rebuilding time three days, it was possible to produce additional ingots equivalent to 576 tons of increased bar mill production. The profit obtained from this additional bar steel production was twice the increased cost of rebuilding when contract help was obtained. This disclosure influenced the operating management to utilize outside contract help to the fullest extent on open-hearth rebuilding rather than our mason department.

I made the point earlier that the amount of detail to be submitted should only be that which is essential for the correct understanding of the report. Obviously, this concept should be considered in relation to the background of the person to whom the report is presented. That is to say, an executive with an accounting background might require more or somewhat different detail than would an executive from the manufacturing field. Our standard practice in connection with reports upon special subjects is to summarize the data and outline the conclusions in a separate summary or covering letter. This is then supported by schedules containing what is considered the minimum pertinent data from which the summary and the conclusions have been drawn. As an example, when the company entered the refrigeration industry in Evansville, it did so on the basis of a summarized report about three pages long. This report contained a very concise recital of the important facts. In support of the summary there was an appendix over 100 pages long and separately bound which contained all of the detailed information which was felt to be required.

Objectivity

I also stated that in all of our reporting we should strive to be just as objective as we possibly can be. In the matter of being objective, accountants have a special responsibility which is perhaps an even broader one than exists in some of the other areas of management. Our reports should at all times be completely factual, or where this is not entirely possible, we should state very clearly the nature and the extent of the assumptions that we have made.

Accountants can contribute to objectivity as far as the business as a whole is concerned by pointing out sometimes to individual departments the possible danger of considering only the results of that particular function of the business. It is conceivable that we could have a failing enterprise in which reports restricted to an individual segment of that enterprise might show statistically a successful operation. For example, the sales department could attain a very high sales volume, but this might be achieved through selling price leaders in which there is little or no profit. Also, the industrial relations department could point to complete freedom from labour trouble which might be the result of conceding to all demands of the employees. The engineering department might take great pride in the fact that there were no field complaints on the product, but this might be the result of designing a

product made virtually of "platinum and ermine". The manufacturing department could prove that the production schedule was being attained every day without fail, but this might be the result of having sufficient "floaters" on the shop payroll so that they could be thrown into the gap wherever a shortage developed. The materials control department could have a very high material turnover and a low inventory but this might be the result of ordering goods in uneconomically small lots and bringing in short items by air express. In my opinion the role of the accountant is to review all these statistical criteria of success to determine if each function is being accomplished in a manner that is beneficial to the enterprise as a whole. If not, an appropriate report would be in order. This requires vision and objectivity.

Sometimes reports can be prepared on the principle of exception and submitted only when there is a definite reason therefor. One of our divisions handles the daily production statement in this manner. If production is being maintained according to the predetermined schedule which is well known by management, it is unnecessary to compile a detailed report each day giving production figures. Management does not want to concern itself with matters which are routine and altogether in-line. In this case management needs a report only when there are deviations from the schedule. It thus serves as a specific basis for corrective action by management.

Frequency of Reports

The frequency with which reports should be issued can vary widely depending upon the subject of the report. Almost any reporting system could stand scrutiny in this regard. It is possible that many reports which are now made monthly should be on a quarterly basis or *vice versa*. Some of the reporting in our factories which is now on a weekly basis should probably be on a daily basis in order to give plant supervision a prompter opportunity for correction of excess or abnormal costs.

In the case of a new product which we put into the field several years ago, we started out by asking for an immediate report on field complaints. As failures became less and less frequent, this report was changed to a monthly basis and later to a quarterly basis. On the other hand, in the same division where this occurred, it was found that a scrap report formerly prepared weekly was not reaching the plant management soon enough to enable them to make a prompt correction of a situation leading to excessive scrap. This report was accordingly changed to a daily basis thereby enabling the plant supervision to take the corrective steps needed to avoid an undue amount of scrap.

We have also developed a form of reporting in the Harvester Company in connection with long-range financial planning. This is based upon the establishment of a budget for capital expenditures for the current year and the succeeding four years. This budget is reviewed quarterly with the executive management and revisions are made whenever necessary. In conjunction with this quarterly capital budget, forecasts of the operating results and financial position of the company are prepared, generally to the end of the succeeding fiscal year. These forecasts and capital budgets form the basis for quarterly discussions by an officers' finance committee.

These quarterly finance meetings are usually held just prior to the regular meeting of the Board of Directors. At the Board meeting these long-range reports are presented for consideration, together with such recommendations as the committee may wish to make.

These reports are most useful to the

management and to the Board, although I do not want to leave the impression that we can accurately predict our capital requirements for a five-year period or even the current financial position to the end of the next fiscal year. However, since these reports are revised each quarter, there is a periodical correction of any inaccuracies. It is similar to a ship sailing across the ocean, which is seldom exactly on her course, but whose oscillations are constantly being corrected until her destination is reached.

These reports make our management more aware of changing trends and financial problems. It enables them to make more intelligent decisions today by recognizing the financial impacts of possible future developments.

Conclusion

In conclusion I might say that my examples of reports which influence management decisions are by no means complete. We have many situations which are arising constantly at the company's various operations and at different levels of managerial responsibility which involve investigation and reporting. This does not mean that managerial decisions are never made without first preparing pertinent data. Many decisions which are on-the-spot decisions, so to speak, must be made every day. Time does not always permit careful deliberation or investigation. But such decisions, even though not supported by formal reports, are, nevertheless, based on facts and generally reflect years of experience and judgment.

There will always be important areas in the managerial realm when decisions should not be made without first obtaining adequate data. When management has learned from experience the value of such data they will be unwilling to proceed without such reports.

ONE MAN'S VIEW

or

A DOG IS ENTITLED TO AT LEAST ONE BITE

WE have been cheered by reading that the Income Tax Appeal Board has disallowed a claimed expense of golf club membership dues paid by an appellant on behalf of two employees. Our private view has always been that one didn't get anywhere playing golf.

On the other hand, sailing ....

* * *

We conclude this note by quoting from "Official Report of Debates — The Senate of Canada — February 5, 1951":

> *Hon. John T. Haig*: Honourable senators, I am in a very fortunate position for, as none of my party colleagues are yet in the chamber, the party for the time being is unanimous in its approval of the words I am going to utter to-night.

Problems Raised by the Undistributed Income Provisions In the Income Tax Act

By Stanley E. Edwards, B.A., LL.M.

The new tax enactments pose many difficulties, but the Companies Acts in Canada create still more

SECTION 95A of the *Income Tax Act* has been in effect now for the greater part of a year. Few statutory provisions have caused such immediate and widespread interest and study. The section is unique in that it has induced taxpayers to contribute millions of dollars voluntarily to the Canadian government. It has the twin virtues of being both appealing to taxpayers and highly productive of revenue. The section has a strong appeal to private companies because it provides a way of solving their undistributed income problems. This is particularly important in the case of private companies whose principal shareholders wish to make provision for the payment of succession duties or for the withdrawal of funds from the company for some other reason.

A private company ordinarily can, upon making an election under s. 95A, arrange its affairs in such a way that all or part of its assets may be distributed to its shareholders free of tax in their hands. This can be done, however, only if the election and payment of the 15% tax are followed by the carrying out of a corporate procedure which will result in a deemed dividend under s. 73 of the *Income Tax Act*. In determining what corporate procedure may be followed it is necessary to consider not only the applicable provisions of the *Income Tax Act* but also of the relevant *Companies Act*, and the general principles of company law. The applicable company law sometimes results in difficulties in determining upon a procedure which can be used in taking advantage of the provisions of the *Income Tax Act*.

Section 95A and related sections have been, on the whole, well worked out and well drafted. However, experience has revealed and no doubt will continue to reveal consequences of the legislation which could not have been readily foreseen. This article will deal with some of the practical difficulties, problems and inequities which have been or may be encountered by companies in formulating plans to take advantage of s. 95A. Some of these arise solely from the terminology of certain provisions of the *Income Tax Act*. Others result from rules of company law which interfere with or render undesirable procedures which, under the *Income Tax Act*, might be employed to take advantage of s. 95A. Consideration will also be given to problems arising under s. 27(1A) which relates to "controlled corporations".

Amount on Which 15% Tax May Be Paid under s. 95A(1)

Under s. 95A(1) a private company may elect to pay the 15% tax on "an amount equal to its undistributed income on hand at the end of the 1949 taxation year minus its tax-paid undistributed income as of that time". It will be seen that the amount on which the company may elect to pay the 15% tax under this subsection is inflexible. A company which had a large undistributed income at the end of its 1949 year, but which has subsequently suffered losses or paid dividends in excess of its post-1949 earnings will be in a relatively unfavourable position. If such a company wishes to take advantage of the legislation, its only right under subsec. (1) of s. 95A will be to pay the 15% tax on an amount which may be considerably larger than its undistributed income at the date of the election.

In this connection the Canadian Tax Foundation has made a recommendation to the Government for the amendment of 95A(1) which would eliminate this difficulty. The recommendation is that a company should be permitted to elect under s. 95A(1) to pay the 15% tax on the lesser of two amounts, namely (a) its undistributed income on hand at the end of 1949 minus its tax-paid undistributed income at that time or (b) its undistributed income on hand at the end of the last taxation year that terminated before the date of the election minus its tax-paid undistributed income at that time.

Definition of Undistributed Income on Hand

A special type of problem is encountered under the present legislation where a company having a capital surplus[1] wishes to capitalize that surplus by carrying out a procedure under which redeemable shares or other securities representing that surplus are placed in the hands of its shareholders. This problem is caused by the wording of s. 73A(1)(a) of the *Income Tax Act.*

Under s. 73A(1)(a) "undistributed income on hand" at any time in any taxation year is defined in such a way that it includes the income of the company up to the end of that taxation year. The result is that if a company wishes to capitalize a capital surplus early in a taxation year, there will at that time be a deemed distribution under s. 73 of an amount equal to the company's undistributed income as at the end of that fiscal period, the amount of which will be unknown at the time of the capitalization. Since at the time of the capitalization it will ordinarily be impossible for the company to have paid the 15% tax on its income for the current year, the earnings of the company for at least a full year will, in the ordinary course of events, be included in the incomes of the shareholders.

In some cases, however, measures can be adopted by which capital surplus can be capitalized without subjecting the shareholders to tax on the income of the company for a full year. This may be done by having the company sell its assets early in a taxation year to a new company which will continue to carry on the same business. The vendor company may receive in consideration for its assets redeemable securities of the new company which it can then distribute to its shareholders on winding up or surrendering its charter. In other cases a company may avoid the difficulty by selling its income-producing assets to an associated company even though it continues in existence. These are rather

[1]In this article the term "capital surplus" is not necessarily used in its usual sense but is employed to describe any surplus of a company not included in its "undistributed income on hand" as defined in the *Income Tax Act.*

cumbersome procedures to be adopted for the purpose of accomplishing so limited an objective. Accordingly, the result frequently is that a company leaves its capital surplus uncapitalized.

In this connection, a recommendation has been made to the Government by the Canadian Tax Foundation that s. 73A(1)(a) be amended so that "undistributed income on hand" of a company at any time during a taxation year will be determined as at the end of the previous taxation year, subject to the deduction therefrom of dividends paid or deemed to have been paid in the current taxation year up to the time in question. If this recommendation should be adopted, the definition would be considerably more satisfactory than it is at present because a company would be able, before capitalizing a capital surplus, to ascertain the amount of the dividend which would be deemed to be received by its shareholders as a result thereof. In addition, the capitalization could be effected without subjecting the individual shareholders to tax at the personal rates on the income of the company for the current year.

Amount of Stock Dividend Which May Legally Be Paid

Where a company has paid the 15% tax on all or part of its undistributed income and wishes to capitalize not only its tax-paid undistributed income but also capital surplus, the question sometimes arises as to the amount of stock dividend which may legally be declared and paid. This question arises particularly in the case of a parent company having one or more subsidiaries which have accumulated undistributed income subsequent to the acquisition of their shares by the parent. If a company pays a stock dividend which is in part illegal, the directors or shareholders may be liable to creditors, particularly after redemption of the shares issued. In addition it is possible that if a stock dividend were to be paid illegally, amounts received by the shareholders on the redemption of the stock dividend would be treated as ordinary dividends for income tax purposes.

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There are provisions in certain of the Companies Acts in Canada, notably the Dominion Act and the Ontario, Quebec and New Brunswick Acts, which provide in effect that a stock dividend may be paid in any amount which the company may distribute by way of cash dividend. Under the Companies Acts of the other Provinces, a company may be empowered by its letters patent or articles of association to declare a stock dividend. Such stock dividend, however, may not exceed the amount which the company is legally entitled to pay by way of cash dividend. Accordingly, it may sometimes be necessary to examine the nature of a capital surplus to determine whether or to what extent it could be distributed by way of cash dividend.

The decisions of the Courts clearly indicate that a dividend may legally be paid from a realized capital surplus. The cases also indicate that in some circumstances at least a dividend may properly be paid from an unrealized capital surplus resulting from writing up the value of an asset. Where, for example, depreciation has been taken on a company's assets which has proved to be greater than the decrease in their value, the directors may ordinarily, subject to the

provisions of the applicable Companies Act, write the assets up to their true value and pay dividends from the capital surplus resulting from such write-up, provided of course that the write-up does not exceed the depreciation which has been taken on the assets. Also, even though no depreciation has been taken on a company's assets, if their value has increased above their cost to an amount which is readily realizable, generally speaking the assets may be written up on the company's books to that amount, and a dividend paid from the capital surplus resulting from the write-up. However, in some circumstances a company may have a capital surplus arising from a write-up in the value of its assets, from which a dividend could not legally be paid.

The question may sometimes arise whether a parent company can legally pay a stock dividend from a surplus resulting from the writing up on its books of the investment in a subsidiary. The writer understands that it is proper accounting practice to write up the investment in a subsidiary on the books of the parent by the amount of the subsidiary's earnings subsequent to the acquisition of its shares by the parent. If this practice is followed, of course, any dividends paid by the subsidiary to the parent would be applied in writing down the investment in the subsidiary. Although there has been no case of which the writer is aware in which the point has arisen, there may be some doubt as to whether a dividend could legally be paid from such a surplus. Therefore, where a parent company wishes to capitalize a surplus resulting from the accumulation of earnings in the hands of a subsidiary, it would appear desirable for the subsidiary to effect a distribution of its accumulated earnings so that they will form a realized surplus in the hands of the parent company. The subsidiary, if it is a "private company", may do this by electing to pay the 15% tax on its undistributed income, declaring and paying a stock dividend to the parent company in redeemable preference shares in an amount equal to its tax-paid undistributed income, and then redeeming, or reducing its capital by paying off, the shares issued by it as a stock dividend. The amount received by the parent company on such redemption or reduction will not be included in its undistributed income but will form a realized surplus which the parent company can clearly capitalize by the payment of a stock dividend.

Parent and Subsidiary Companies

Some of the most difficult problems raised by section 95A relate to parent and subsidiary companies. If, subsequently to 1949, a subsidiary distributes part or all of its 1949 undistributed income to its parent company by way of dividend, the amount distributed will constitute post-1949 earnings in the hands of the parent. The parent company will, therefore, not be entitled to pay the 15% tax on such undistributed income under s. 95A(1).

In such situations it is usually more advantageous for the subsidiary not to make any distribution of its 1949 undistributed income by way of ordinary dividend, but rather to distribute such undistributed income by electing to pay the 15% tax thereon, paying a stock dividend in redeemable preferred shares and then retiring those shares. The amount received on such a distribution will not be added to the undistributed income on hand of the parent company as would an ordinary dividend but nevertheless will be available for distribution. However, the parent company cannot distribute this surplus to its individual shareholders without subjecting them to tax at the personal rates on its undistributed income on hand on which it has not paid the 15% tax. As is explained above because

of the way in which "undistributed income on hand" is defined at the present time, this will ordinarily include the earnings of the parent company for at least one year.

In this connection, the Canadian Tax Foundation has put forth a recommendation to the Government that the Act be amended so that where a dividend is deemed, under s. 73, to have been received by a corporation from another corporation having tax-paid undistributed income, the receiving corporation's portion of the payer corporation's tax-paid undistributed income shall be added to the tax-paid undistributed income of the receiving corporation. It is understood that the Departments of Finance and of National Revenue are giving consideration to this suggested amendment.

If such an amendment should be enacted, tax-paid undistributed income of a subsidiary company could be distributed in such a way that it would form tax-paid undistributed income in the hands of the parent company. This amount could then be distributed by the parent company to its shareholders free of tax in their hands. The result would be that public companies with subsidiaries would be enabled to take advantage of s. 95A with respect to the undistributed incomes of their subsidiaries. It is not clear at present whether government policy will be to make opportunities of this kind available to public companies. This general question is discussed at a later stage in this article. If the Government should not wish to extend the operation of s. 95A to public companies, it may nevertheless afford substantial relief to private companies by amending the legislation in the manner suggested by the Canadian Tax Foundation, subject to a limitation of the amendment to cases in which the receiving corporation is a private company which is itself entitled to make an election under s. 95A.

Redemption of Preferred Shares

Companies incorporated in certain jurisdictions may capitalize tax-paid undistributed income by issuing stock dividends in redeemable preferred shares which may then promptly be redeemed. However, companies incorporated in other jurisdictions are subject to statutory restrictions on the redemption of preferred shares. The Dominion *Companies Act* and the Companies Acts in Alberta, Saskatchewan, Nova Scotia, British Columbia and possibly Manitoba, contain provisions which in effect prohibit redemption of preferred shares except out of the proceeds of a new issue of shares or out of profits.[2] A company which has issued preferred shares as a stock dividend will ordinarily have capitalized all of its accumulated profits. Consequently, the effect of the provisions above referred to is that such preferred shares cannot promptly be redeemed except out of the proceeds of a new issue of shares.

In the case of companies incorporated under statutes which contain provisions restricting the redemption of preferred shares, the tax-paid surplus and any capital surplus which has been capitalized may be distributed, however, by reducing capital by paying off the preferred shares rather than by redeeming them. In order to carry out a reduction of capital there are certain procedural steps, such as the circularization of creditors, which must sometimes be taken by reason of the provisions of the relevant *Companies Act*. However, if the procedure is carefully worked out and if the company is solvent and will clearly be in a position to pay all its debts after the proposed reduction of capital, these requirements can usually be minimized.

If it is not desired that the company

[2] The Companies Act of British Columbia also permits the redemption of such shares out of the proceeds of an issue of debentures.

distribute its tax-paid undistributed income immediately, but rather that it should be placed in a position to do so promptly when the need arises, a different procedure may be followed. The company may reduce its capital and, instead of distributing cash to the shareholders on such reduction, may issue notes or debentures to them in the amount by which its capital is reduced. Alternatively, and perhaps preferably, the company may distribute cash to its shareholders on the understanding that the shareholders will then loan the cash received by them back to the company. If necessary, the cash required for such distribution could be borrowed temporarily from the bank. It would appear probable that the interest payable to the shareholders on such a loan would be deductible in computing the income of the company.

Problem of Shareholders Who Are Trustees

Where a stock dividend is issued to a shareholder who is a trustee, the question frequently arises as to which of two or more beneficiaries of the trust is entitled to the stock dividend. Where the trust instrument is silent as to the disposition of stock dividends received by the trustee and where one beneficiary is entitled to the income of the trust and another is entitled to the capital, the question arises as to whether the stock dividend is income or capital of the trust. There have been numerous British cases in which it was held that a stock dividend was capital in the hands of a trustee. However, there have been at least one British case and two Canadian cases in which the contrary conclusion was reached by the Courts. For this reason the law on this point is not entirely certain. Each case must be decided on its own facts and it appears from the decisions that the result can be influenced to some extent by the form in which the resolution declaring the stock dividend is expressed.

Where the beneficiaries of the trust are of full age it may be possible to solve the problem by having the beneficiaries of the trust agree as to the manner in which the stock dividend shall be treated by the trustee. However, this is not possible where some of the beneficiaries are not of full age. Where shares of a private company are held by a trustee, before a stock dividend is declared by the directors, consideration should be given to its ultimate disposition as between beneficiaries of the trust. When a new trust is being established, part or all of the property of which consists of shares of a company, specific provision should be made in the trust instrument as to the disposition of stock dividends received by the trustee. Also, in drawing wills this point should be kept in mind and existing wills should be reconsidered as a result of the new legislation.

Residents and Non-Residents

Awkward questions sometimes arise where some of the shareholders of a company are residents and others are non-residents. In some such cases it is clearly in the interests of the shareholders who are resident in Canada for the company to pay the 15% tax and then to effect a capitalization or a distribution of the company's tax-paid undistributed income. However, such action may be obviously contrary to the interests of the shareholders who are non-residents.

The nature of the problem presented in such cases will depend upon whether the residents or the non-residents have control of the company. Non-resident shareholders will not usually be anxious that the company should make an election to pay the 15% tax. Therefore where non-residents are in control of a company the resident shareholders may be deprived of the benefit of section 95A.

If, on the other hand, the resident shareholders are in control of the company, they may wish to pay the 15% tax and to effect a capitalization of the tax-paid undistributed income of the company, even though this might result in virtual confiscation of the interests of the non-resident shareholders under the tax laws of the countries in which they are resident. If the shareholders who are not resident in Canada do not have the right under company law to prevent the proposed action, an obvious injustice might be worked upon them.

There may be a question, however, whether the directors of a company have power to make an election under section 95A without the consent of all or substantially all the shareholders, particularly if some of the shareholders could not possibly benefit from the making of such an election. Even though the non-resident shareholders of a company are in the minority, the directors may be well advised not to make an election under section 95A or to effect a capitalization of the company's tax-paid undistributed income, if such action would be prejudicial to the interests of the non-resident shareholders and has not been approved by them. It is therefore possible in the case of any company having non-resident shareholders that the resident shareholders will be deprived of the benefit of section 95A, unless they can induce the non-residents to sell their shares to residents of Canada.

The difficulties above referred to might be alleviated if the Government were to raise the question with governments of other countries. Provisions might be worked out either in international taxation agreements or in the taxation statutes of other countries which would allow some kind of tax relief to the non-resident shareholders of a Canadian company which has paid the 15% tax and has capitalized its tax-paid undistributed income.

Public Companies and Controlled Corporations

At the time when s. 95A was passed, subsecs. (1A) to (1F) inclusive of s. 27 were also enacted. These subsections deal with "controlled corporations" which include any resident company the control of which has been acquired by another company after May 10, 1950. The definition of "private company" in s. 95A(3) includes such controlled corporations regardless of the number of their shareholders. Section 27(1A) provides, generally speaking, that where a controlled corporation pays dividends out of its surplus which existed at the commencement of the taxation year in which the control was acquired, such dividends will be subject to tax in the hands of the controlling company at the regular corporate rates, unless the controlled corporation has paid the 15% tax on such surplus. In other words, if the 15% tax has not been paid on such surplus, tax-free dividends may be paid to the controlling company only to the extent of earnings of the controlled corporation in completed taxation years during the control period.

The purpose of these provisions was presumably to discourage any company which purchases the shares of a second company from using the surplus of the second company to pay part of the purchase price. In several instances a company has acquired control of another corporation subsequent to May 10, 1950, for the apparent purpose of causing the controlled corporation to make an election, pay the 15% tax on its undistributed income and then proceed to capitalize the resulting tax-paid undistributed income. It is evident that the controlling shareholders of certain companies may, if they wish, take advantage of section 95A in this way. It is possible that this development was foreseen and welcomed by the Government because it has resulted

in the 15% tax being paid on surpluses which otherwise would probably not have been distributed. It may even be that the Government plans to extend the application of section 95A to all public companies. At the time the legislation was introduced in Parliament in May, 1950, the Minister of Finance stated "after we have seen how this works for a year, it may be possible to extend it to public companies".

There are several reasons why it would appear that section 95A should be extended in its application to public companies. There does not appear to be any logical reason for distinguishing between a private company and a public company except that the undistributed income problem is likely to be less acute in the case of a public company. However, the fact that many public companies would not wish to take advantage of the provisions does not appear to be a good reason for denying them the opportunity of doing so. Furthermore, if some public companies can qualify as private companies by becoming controlled corporations, the legislation appears to discriminate against other public companies, the controlling interest in which is not held by any one group and which are therefore unable to qualify as "private companies". It would therefore appear that the fairest way to deal with the problem would be to make s. 95A applicable to all companies resident in Canada.

Section 27(1A)

Section 27(1A) may in some circumstances occasion considerable hardship. Under this subsection, if a controlled corporation has not paid the 15% tax on all of its pre-control surplus, any dividends paid by it out of its pre-control surplus will be taxable in the hands of the controlling corporation at the regular corporate rates. However, the controlled corporation may not be entitled under s. 95A to elect and pay the 15% tax on all of its pre-control surplus. It may have acquired substantial surplus after the end of its 1949 taxation year but prior to the control period, but may not have paid substantial dividends between the end of the 1949 taxation year and the time at which control was acquired. In these circumstances the controlled corporation would not be entitled under the terms of s. 95A(2) to make an election or to pay the 15% tax with respect to such surplus until some of its earnings in the control period have been distributed by way of dividend. Therefore, until an election could be made with respect to such surplus, no dividends could, as a practical matter, be paid by the controlled corporation, except out of its earnings in completed taxation years in the control period. It may therefore be difficult to sell the controlling shares of any company which has acquired a substantial surplus after the end of its 1949 taxation year but which has not paid dividends since that time substantially equal in amount to that surplus. This problem will obviously become increasingly more critical as time goes on and as corporations acquire more substantial post-1949 surpluses.

The difficulty may be forestalled by the adoption by companies of the policy of paying out approximately 50% of their earnings in each year by way of ordinary dividend. A company which has followed this course will be entitled under s. 95A(2) to elect and to pay the 15% tax with respect to its post-1949 surplus. However, this solution may not appeal to some companies which may wish to plough back more than 50% of their earnings into the business. Furthermore, this policy might not be adopted by a public company if it is not foreseen that the controlling interest will ever be acquired by another company. For these reasons the combined effect of secs. 27(1A) and 95A may

result in considerable hardship in some cases.

Section 27(1A) also causes difficulty where a holding company, which has controlled one or more subsidiaries since prior to May 10, 1950, sells its assets to a new company controlled by the same persons. Such a sale may be carried out for reasons wholly unconnected with undistributed income problems or taxation considerations. Nevertheless the result of the sale will be that the subsidiaries become controlled corporations. Unless the subsidiaries pay the 15% tax on all pre-control surpluses, they will be unable to pay dividends to the new holding company except out of earnings in completed taxation years in the control period.

Conclusion

It will be seen that certain difficulties and inequities may arise by reason of s. 95A. Some of these difficulties and inequities will possibly be reduced or eliminated by amendment of the legislation. Some of the problems which face private companies seeking to take advantage of s. 95A result from rules of company law. It is not easy to see how these difficulties could be reduced substantially by the amendment of s. 95A or related sections of the *Income Tax Act,* unless the basic scheme of the legislation were to be altered. Many problems would disappear, for example, if companies were permitted to distribute tax-paid undistributed income by way of ordinary dividend which would be free of tax in the hands of their shareholders. Unless, however, some such major amendment were made in the present provisions of the *Income Tax Act,* no means of escape from the consideration and working out of these difficulties is readily apparent.

A Recent Book

A System of Industrial Administration, by Edward E. Webster; published by Gee and Co. (Publishers) Ltd., London; pp. 120; price 22/ post free

In a relatively few pages this subject has been given an exceptional coverage. In this volume the author not only describes a suggested administrative procedure for a medium or small-sized manufacturing concern, but also illustrates a complete set of appropriate forms to be used in conjunction with the proposed procedure.

There is an outline of the course of an order from the time it is received until it is shipped and the author covers all the paper work necessary to insure the proper productive, administrative and accounting control for efficient handling. The chapters on the purchasing, receipt, handling and storing of goods are profusely illustrated with forms required in these operations.

Mr. Webster stresses the importance of cost accounting in modern industrial administration since management relies on cost information to formulate not only policies but prices, especially in a competitive market. The chapter on cost and works accounting explains in detail a system necessary to compile the pertinent data as efficiently as possible. The latter chapters cover wage structure and compilation and, in addition, the control of staff records.

M. P. GREENHILL, C.A.
Oshawa, Ontario

Office Production And Control

By R. L. B. Joynt, C.A.

Production controls must be exercised in some form or other by every office manager

THE word "production" is still an unfamiliar term to most office people. We all understand factory production statistics. A certain factory turns out 50 tractors per day, or 1,000 tires per day, or 5,000 rolls of film per day — they are tangible and easy to visualize. On the other hand, office work seems somewhat intangible — we are singularly unimpressed that "A" company makes 100 ledger entries per hour, or "B" company files 900 bits of paper per day.

This unsatisfactory attitude quite possibly stems from the idea that offices do not produce anything which provides revenue. It represents overhead expense or burden; if you will, it is a necessary evil in the eyes of management, not causing too much concern, but at the same time receiving little attention.

Efficient production control is, of course, the goal of every office manager. At the same time, control of production is, in my opinion, something of a misnomer. The volume of office work, in the final analysis, depends on factory production and sales to the trade, neither of which factor is controllable by the office. If, however, we have no control of the quantity, we can well maintain an interest in the flow of work, as well as its quality.

Therefore, unpalatable as is the subject of "Office Production and Control", let us approach it with a critical but unprejudiced eye.

Production Analysis and Work Measurement

Production analysis and work measurement are quite closely related.

Production analysis is the breaking-down of the individual job or of the work in a department into satisfactory measurable units. These units may be key strokes, square inches of typing, letters transcribed, copy typed, invoices typed, billings extended, prices entered, postings made, columns added, cards sorted, cards key-punched, cards tabulated, letters opened, letters filed, letters mailed, machine calculations made, or any combination that is considered reasonable or practical.

Work measurement is the logical next step of totalling the units by the day or by the job. This total may be a basis for pay calculation, or perhaps

An address to the Office Management Training Course at the University of Toronto, sponsored by the National Office Management Association, Toronto Chapter, November 1950

more commonly it may be compared with previous performance, estimated requirements, or established standards.

After a brief study it will be evident that many of these units must be used with discrimination. The daily number of invoices typed will provide satisfactory information as to whether that department is adequately staffed, but the same basis might be quite inaccurate as a method of remuneration.

Measurement by key strokes, being a mechanical unit, may seem an obvious choice. However, a key-stroke counter on every typewriter in an office will mean a sizeable investment. At the same time it will be necessary to "weight" key strokes. Copy work rates lower than transcribing, but where does multi-copy statement work fit in? Should there be a penalty for errors, or a bonus for perfect or near-perfect work? In short, there is no ready-made formula, no cut and dried method. Each situation will require different treatment.

There is another important item which has nothing to do with the choice of unit. It is the overcoming of inertia in the recording of production. There are few companies, indeed, which have placed as much importance on office production analysis and control as they have on comparable manufacturing functions. Many office supervisors will frown on "wasting" time on any new-fangled production analyses for such reasons as: "the work must all be done, anyway, there is nothing you can eliminate"; "we are doing the best we can, why are you checking up on us?"; "production records mean *extra* work with no offsetting advantages". Therefore, be prepared to do a good selling job to justify the advantages of production analysis and controls.

Setting Production Standards

Office standards might also pay attention to equipment, such as typewriters, to supplies such as paper, erasers, to conditions, such as light intensity, or to safety standards. Although all of these items have varying effects on office production, reference will be made mainly to standards of production.

What is a standard? Let us not confuse standardization with simplification — two important but unrelated functions of office management. A N.O.M.A. bulletin defines a standard as representing "the best *current* knowledge of a practice or an item, to meet the necessities of current conditions". Simplification, on the other hand, is the reduction or elimination of some of the steps in a procedure. Whereas simplification reduces the number or length of certain steps, standardization establishes the uniformity of the steps actually performed.

What is required of a standard? Or to say it another way, what desirable factors should a standard attempt to achieve?

(1) *Accuracy and Precision*

In the first place, any standard must not only be accurate, but should have the proper degree of precision. Paper standards of, say 8-1/2 x 11, would allow possibly 1/16th inch variance, whereas a 3 x 5 card should have a tolerance of possibly 1/64th inch.

The degree of precision will depend to some extent on its use. Normal or standard key strokes per hour for an order typist might be an average of the department production, and provide an eminently satisfactory yardstick. But a standard on the same operation, for use as pay basis, should be substantiated by time-study.

(2) *Workability*

In the second place, standards must be workable. Unreasonable or indefinite requirements will cause confusion and discontent. For example, standards of payroll calculations for "A" company cannot be used by "B" company unless conditions are identical. As an actual example, one company quotes a standard for posting debits and credits to bank customers' accounts on one well-known bookkeeping machine of 450 per hour, whereas another company posts customers' accounts on another well-known bookkeeping machine at approximately 125 per hour. The reason for the difference is not the equipment, not the operator, but the system. The second company codes all entries and accumulates monthly sales at the same time and this means several additional operations.

Do not copy another firm's standards and expect to install them in your own office without variation.

(3) *Flexibility*

Flexibility is a third factor. For example, a standard set for a regular, standard typewriter would require variation when used on an electric typewriter.

(4) *Acceptability*

And finally, a standard must be acceptable. Rank and file as well as supervision must understand thoroughly what is being done, and must be sold on the merits of the procedure. A clerk who is not in agreement with a change in work procedure can make it unworkable in spite of the management's best efforts.

When Should a Standard Be Set?

It will be evident that a standard would be superfluous on a job requiring a few minutes' typing each week. Generally speaking, therefore, standards will be most useful and successful where (1) there is a relatively large or concentrated volume of work, e.g. payroll calculations, or (2) there are repetitive operations by a number of people, e.g. order typing, invoicing.

Following graduation from the University of Western Ontario, Mr. R. L. B. Joynt, C.A. continued his studies and was admitted to the Ontario Institute in 1933. After practising his profession for several years, he joined Canadian Kodak Co., and is now assistant comptroller.

How Is a Standard Set?

Before a standard is set, the job or procedure must be studied in detail. Flow charts may be used. In many instances mere study of routing will produce items which require adjustment. It is essential that the procedure which is to be standardized be as simple, workable, and efficient, as possible, before standards are set. Any material changes in method may nullify results and require complete re-study.

The factors to be measured must be carefully selected. Numeric or automatic measurement should be preferred. Avoid necessity for judgment, wherever possible. And, finally, define specifically the method of measurement as well as the qualifying conditions.

Professor Slater of Evansville College warns that "adopting time-study techniques, which have long been successful in the plant, to the office situation has met with many failures". He concludes, however, that, with proper realization of their limitations, and with the co-operation of supervision and management, time standards can bring office costs under more scientific control.

Handling Peak Loads

Of all the office manager's duties, spreading the work load evenly over the

day, the week, or the month, is one of his most thankless tasks but at the same time an unavoidable one. It seems that every supervisor calls for help when he is overworked, but does he rush to you when his department has spare time on its hands? This last remark, however, provides a key for solving many peak-load problems. All departments are not busy at the same time. By gaining the confidence and co-operation of the department supervisors, the office manager is often able to shift work, or personnel, between departments to handle peak loads.

This is not exactly a scientific approach but it is one that will be found very worthwhile. Is there any other approach to this thorny problem?

Scheduling will often provide assistance. Although its primary purpose is to insure that work is performed to meet departmental deadlines or overall company requirements, an important by-product may be the elimination of bottlenecks. To express this situation in another way, proper scheduling will improve co-ordination between clerks, and between departments; and in the process, the reduction of work peaks may provide savings in excess of those provided by the scheduling.

Here is a simple illustration of what can actually happen. Certain analysis reports were always late for financial closings. The Department "A" felt that Department "B" was responsible but Department "B" put the onus on Department "C". However, Department "C" maintained that they were making the very best time possible, after receiving the work from Department "D".

It was decided to schedule the work. In this process it was found that every Department was doing its work efficiently *but* .... The completed analysis was turned over by Department "C" to Department "D" which needed it for about half an hour to prove summary totals. As Department "D" was always quite busy, the report usually stayed here a couple of days until it was turned over to Department "B". No one had ever asked Department "D" for the report so they had no idea there was any particular rush. In this case, scheduling eliminated a bottleneck and reduced a peak load.

Seasonal Peaks

However, there are other peak loads caused by seasonal business, financial closings, monthly statements, payroll changes, some of which can be anticipated and others which cannot. Each situation requires on-the-spot judgment as to the nature and treatment necessary.

So far as humanly possible, anticipate peak-load requirements to staff. Unless a real emergency arises, give adequate notice of the necessity for overtime. Nothing disgruntles a clerk quite so much as being required — sometimes on pain of dismissal — to cancel a date with the boy friend.

However, it may be impossible to handle peak loads by working overtime with the present staff (or, as is sometimes the case, the present staff after allowing for sickness and unexpected resignations). Public stenographers, duplicating and tabulating services are available to cover unusual conditions such as sickness or mechanical failures.

At the same time, some offices have built up loan "pools" of office personnel or machines. For instance, one company has a machine pool of several older typewriters, an adding machine, and an electric calculator. The trade-in value of this equipment is comparatively small but it is seldom that the pool is intact. Equipment may be borrowed by a phone call, but, of course, any permanent equipment, installed in a department, must be requisitioned in writing and properly authorized.

Another company actually maintains a small clerical staff available on call. The reduction of overtime and the improvement in employee morale, as well as the avoidance of overstaffing of departments, has, it is felt, justified the experiment. At the same time the supervisor has been partially relieved of concern over work peaks as well as work shortages.

Incentives

Piece-work or bonus plans have been used successfully in the factory for years, but have been comparatively slow to make their appearance in most offices.

However, it can definitely be argued that many of our present pay methods are not efficient, economical, or equitable. Incentives may point the way to reduced unit office costs as well as providing a more uniform method of payment for what is produced.

Perhaps one of the main objections to introducing incentives into the office is the fact that, in the final analysis, all office work cannot possibly qualify. This, however, appeared to be the same situation in the factory several years ago, but many jobs originally considered unmeasurable are now on standards. At the same time, caretaking, stock room, power house, and shops labour (representing a fair percentage of the plant total) are not yet on standards.

In other words, straight time work and incentive work, it has been proven, can operate without conflict in the factory. This has not been done without opposition, but a consistent, tactful, and scientific approach eventually established the soundness of the policy in the eyes of management, as well as demonstrated to employees the advantages of wages based on productivity.

There are certain maxims which must be understood in setting incentives.

1. The salary structure should be determined independently of the incentive system. That is, a bonus must be for additional work over and above what normally might be expected.

2. Standard procedures must be set up and observed. This does not mean that standards cannot be changed, but it does mean that when standards are changed, incentive basis should be varied accordingly.

3. Careful study of work must be made, preferably by experienced time-study men, and a unit of measurement determined.

4. Incentive bonus must not be changed unless there is some definite revision in method, equipment, or materials.

5. The basis should be simple and easily understood, and the bonus should be large enough to create an urge for extra production.

One company uses a bonus plan in its central transcription department. For fully qualified girls, this is a wage incentive plan, with guaranteed base rate, using a key-stroke count, with each class of work "weighted" based on actual time-study. In addition, there is a "quality" bonus of 5% if less than 2% of letters are returned because of transcription errors. This system is working out so well that no change in equipment would be contemplated before being tested in the transcription department. In recent tests of the new types of dictating equipment, one type was disqualified because the machine speed was too slow for the top operators.

Typing of railway freight bills by male typists is on a rate per bill basis, averaged for the group; in the factory it would be called a group piece-work rate. This job has been operating successfully on this basis, with some modifications, for several years.

Undoubtedly there are many other actual examples. However, a spot survey

of the Toronto area would indicate that most office work is performed on a straight time basis.

Summary

From the foregoing remarks, perhaps we may be permitted to make some deductions.

Production controls must be exercised in some form or other by every office manager. To some extent, the nature of these controls depends on the office manager himself. For example, one branch keeps numerous records not maintained by another branch. Yet both branches are considered by head office to be operated efficiently, and furthermore, neither branch has been instructed to change its methods.

Controls are exercised both formally and informally. Generally speaking, the larger the office, the greater the need for formalized written reports. Written reports, however, can never be a substitute for personal supervision.

The actual recording of production is a relatively simple matter, although mechanical equipment such as "counters" will be required for some operations. The value of production records is greatly increased when they can be compared with accepted standards. At the same time, however, standards should generally be set only on established written procedures by experienced personnel. Once standards have been established and accepted, the introduction of incentives on certain office operations may be found practical.

It is perhaps not too much to say that there is room for improvement in every office. At the same time the head of the office services division of a large industrial organization highlights the constantly changing aspect of office controls when he writes, "There is a definite scarcity of formal procedures [on these matters]. It is my experience that before the last period is placed upon such a project, the first paragraph is obsolete." Such a statement from a successful methods supervisor is not in the least cynical, but challenging.

Let us conclude that our first office production studies may or may not show savings. It is only by continuing work and consistently applied study that we can obtain maximum results.

THE SOCIETY FOR ADVANCEMENT OF MANAGEMENT

The second annual one-day Industrial Engineering Conference will be conducted by the Montreal Chapter of the Society for Advancement of Management on March 30, 1951 at the Mount Royal Hotel, Montreal. The general theme of the conference is "Engineering a Profit Path".

Audits of Closely-Held Companies

By F. A. Nightingale, C.A.

Here, more than elsewhere, the personal element is most important

IT is well to recapitulate a few of the reasons for the audit appointment:

1. To present certified financial statements for banking and credit purposes.
2. To present certified financial statements for tax purposes.
3. To present to the shareholders annual financial statements indicating in proper accounting form the result of operations for the year and the financial position of the business.
4. To comply with statutory requirements.
5. To verify the accuracy and veracity of the staff and accounting records.

These do not constitute all the reasons for an audit appointment but only the more usual ones.

Restricted Audits

The appointment of auditors of small companies and of closely held family corporations is sometimes made verbally (confirmed subsequently on the minutes of the company), and often for specific purposes. Audits that are restricted in scope should be clearly defined and in writing.

The auditor of a closely held company, which may be a family company or a company whose shareholders all actively participate in its operation, is confronted with problems much more delicate than are involved in an audit of a publicly owned company. Some of the problems of the auditor are intensified (and sometimes minimized) by the attitude of the shareholders. Quite frequently when the shareholders are employees of the company the following problems arise:

(a) Lack of appreciation by the chief shareholder-manager of the auditor's responsibility for the verification of assets and liabilities of the company.

(b) Difference of opinion as to personal expenses which in the opinion of management should be charged as operating costs.

(c) The necessity for an independent examination by an auditor to ensure that company regulations are complied with, particularly when, as in the case of Nova Scotia, no penalty is imposed for non-compliance with certain sections of the *Companies Act*.

(d) Misunderstanding by the chief shareholder of the reason for disallowing

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the reserve for merchandise as inventoried, reserve for bad debts, etc. He cannot understand why these reserves are disallowed for tax purposes when all he seeks is protection against changing economic conditions, etc.

(e) Interpretation of the *Income Tax Act*. This problem is complex with large companies but it is a real problem with a small company. In a large company with its battery of departmental experts, problems may be interpreted and solved, but in a small company, it is the auditor who must find the solution. The auditor is, in fact, a guardian of his client's interest in respect of tax matters.

(f) Determination of the total revenue of the company. Often a business is so small that many duties are performed by one individual; there is no cross checking, no internal check. Often the system is so loose that unless the owner has some technical knowledge of accounting, errors of omission as well as commission occur.

(g) The officers usually require from the auditors business advice and guidance.

(h) It is recognized by the auditor of small companies that his duties consist not only of an audit in the usually accepted understanding of an audit but often in addition of instructing the bookkeeper and even completing the accounting records, preparing annual financial statements with all of their necessary detail, preparing, closing and adjusting the books of account, and inevitably preparing and completing income tax and other governmental returns.

(i) Lack of understanding by the chief shareholder of the distinction between profit, as shown by the financial statements, and income subject to federal and provincial taxes.

(j) The often critical attitude of the chief shareholder of the mechanical detailed checking of every posting in the accounts that have been under his direct supervision or control.

Friendly Spirit

All of these problems can be met if the auditor approaches his task in the spirit of friendly understanding and also if the relationship between the few shareholders of the small company is a happy one. If, however, the relationship between shareholders is not harmonious the problem of the auditor is much more delicate. In many instances he has to be a diplomat extraordinary to retain his professional prestige.

The auditor of small companies must be a good accountant, a tax expert, a good financier, have good business judgment, be a good diplomat, and, finally, something of an accounting magician.

The above are some of the problems. Now I shall deal with some of the methods necessary to present an unqualified certificate. I do not propose to deal with the ever-present problem of an "audit certificate", its value, or how much or how little it means, but rather the general acceptance of an unqualified auditor's certificate attached to financial statements.

Verifying Entries

It has been stated many times that all recorded transactions can be checked and verified; the problem is how to verify that all transactions have been recorded and to know how many of the recorded transactions should be checked to enable a financial statement to be presented with an unqualified audit report attached thereto. The system of internal check in use (if any) must be carefully yet diplomatically examined. If it is found that a good system is in use, reasonable tests can be made and often this is sufficient. If, however, it is discovered

that the internal check is of no value, a complete detailed audit may be necessary. When no system or no internal check is in use, then, depending on the auditor's sixth sense, detailed examination of each and every item may be necessary.

To what extent is a detailed examination necessary to satisfy the auditor? I would suggest:

(a) *A detailed examination of the minutes of shareholders' or directors' meetings.* Often these are incomplete. At all times before the audit is complete these minutes should be in proper order and any extraordinary items found in the operation of the business should be recorded therein, e.g., authorization of salaries of shareholders.

(b) *A verification of all assets of the company; the method of verification must be left to the auditor.* Items such as cash on hand, bank balances, accounts receivable, investments, realty and other fixed assets are simple matters. The question of verification of stock-in-trade is one that requires great care; the overstating or understating of quantities, the valuation, allowance for obsolescence, the inclusion of items not previously inventoried, etc., are items that always present problems. The method of inventory-taking should be carefully analyzed, price percentage taken into consideration, original costs, market costs, warehousing and handling, manufacturing and processing and, where possible, the percentage mark-up, all these and others must be taken into consideration when attempting the valuation of inventories. If the gross profit percentage is reasonably constant then no particular problem arises; if however, using the percentage method, a discrepancy is shown then other methods of verification, and often a retaking of inventory, is essential. I well remember in my early practice a client of a medium-size business making

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the statement that while he was interested in the accounts that were recorded in the books and the results of operations, which could always be verified, he was much more exercised as to the control necessary to guarantee within reason that all sales made were recorded therein. He had suffered losses as a result of insufficient control of sales.

Some Specific Items

It is my considered opinion that verification of sales must be made. I do not mean a detailed checking of every sales order but sufficient examination and testing to satisfy oneself that merchandise sold and delivered is recorded in the accounting record. Also, inventory controls are desirable where practicable.

Such items as credit notes and sales adjustments are automatically scrutinized by the auditors.

Verification of cash income often presents problems. Many small businesses use synoptic cash journals and incoming cash is recorded therein, sometimes deposited to bank intact, but often used for disbursements. The mailing of verification statements for customers' accounts receivable is general practice today, which to a large extent minimizes loss of cash receipts, often too, the returned verification statements disclose interesting items.

In numerous small companies one person performs many duties and may also have signing authority and power of attorney. A detailed examination of the bank account not only verifies its mathematical accuracy but indicates and supplies to the auditors valuable informa-

tion pertaining to the operations of the business and, further, often determines the expense or capital distribution.

In large corporations, with an efficient internal control, together with independent departmental operators, audit tests may be sufficient, but in a small company a detailed examination within reasonable limits of the cash and bank disbursements is necessary.

The verification of liabilities is often difficult. Usually the only knowledge an auditor has of liabilities is through the examination of invoices and statements. A well financed company does not offer the same difficulty in verification of liabilities as a company with stringent finances. Communication with creditors verifying the accuracy of the accounts is desirable.

The extent of the examination of the purchase invoice is again an individual problem. If a good system of internal audit is in use, testing may be sufficient. If, however, the company is small and the accounting is performed by bookkeepers who have many other duties in addition to account-keeping a complete detailed check is often necessary. This question will depend on circumstances.

The auditor must satisfy himself of (a) clerical accuracy; (b) propriety of charges, — capital or revenue, personal or trading; and chart his course accordingly.

All the Talents Required

The problem of the practitioner of small companies is in many cases the same as with larger companies, the difference being in the division of labour. Large companies have their departments and cost controls and internal audits. Small companies, with their limited staff, depend to a greater degree on the ability of the auditor to present financial statements in accordance with the statutes, the requirements of the Tax Department, and to present to the shareholders a correct statement of the operations of their company, the weaknesses of its operation, and often an analysis of its operations.

Fortunately, the relationship between clients, (be they individuals, partners, or shareholders), and the accounting profession is most friendly. Our profession is held in the very highest regard and it is imperative that we continue with skill, diligence and integrity in all our relationships with our clients, be they active in the management of business or simply stockholders. The field of the practitioner has grown during the last few years. We must continue to uphold the dignity and high ideals of our profession and at the same time be realistic in our dealing with small companies and proprietorships.

The Canadian Tax Foundation: Its Functions and Aims

In four years the Foundation has created for itself great prestige

Objects of the Tax Foundation

ALTHOUGH the Canadian Tax Foundation was established four years ago by the joint action of The Dominion Association of Chartered Accountants and the Canadian Bar Association, and has grown with their sponsorship and support, many members of both Associations are still unaware of the benefits which the organization offers to its members and the country at large. Today, when the Canadian economy is moving to a near-war footing with the prospect of increasing taxation, the Foundation's objects have added point, and should be widely known.

The practical objectives of the Canadian Tax Foundation are two-fold:

(a) Research in tax legislation, with a view to good order in the substantive provisions and coherence in the underlying policies of our tax laws;

(b) Review of the continuing process of tax amendment coupled with representations as required in order to counter-balance the necessary initiative of the Government's experts in this technical and constantly changing field.

With these objectives there is the added purpose of contributing to better informed public opinion. Bulletins and research studies are published on topical subjects, and their scope will increase with the growth of the Foundation's facilities. The publication of authoritative books has also been undertaken, the first of which, on "The Canadian Tax System Today", is now in the printers' hands. A specialized tax library is being built up, and is available for anyone who wishes to use it.

The Foundation has no political affiliations or partisan sympathies and is independent of any class or group of taxpayers. The private financial support on which it depends, most of which comes from the business community, carries no stipulations affecting any subscriber's interest under the tax laws. This principle of independence is constitutionally secured by the provision that the Foundation's affairs and policy are controlled by a Board of

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Governors elected from practising members of the two parent Associations across the country on annual nomination by their respective presidents; and it is confirmed by the expressed attitude of the founding subscribers that they would be wasting their shareholders' money if the Foundation's standing in this respect were open to question. The tax authorities, to whom this feature had to be demonstrated, now recognize and respect it.

The successful accomplishment of the Foundation's objects is a direct interest and responsibility of the members of both professions. It is a unique example of professional collaboration between tax practitioners; it offers an opportunity for public service in a field where such service is needed and where no other members of the community have the same qualifications; it involves a responsibility in the use of funds subscribed for this purpose by clients; and participation in the Foundation's activities cannot fail to give its members a better grasp of the subject matter from the Government's standpoint as well as the taxpayer's.

If this were taken as a complete statement of the Foundation's claim to the support of lawyers and accountants in Canada, it might simply be regarded as another call to the exercise of public duties. Readers may ask what benefits, more specifically, are derived by the Foundation's members, by their clients, and by the Government itself.

Benefits to the Professions

The governors and members of the Foundation serve without remuneration. The paramount benefit that its creation has brought to the two professions is wider collaboration between them. Both the lawyer and the accountant are becoming aware that neither has an exclusive competence in advising clients on tax problems.

Taxation today invades every sector of productive or gainful activity and neither the accountant nor the lawyer can give much guidance as to the consequence without the help of the other. No item in a tax return is exclusively a matter of accounting principles and no provision of the *Income Tax Act* is susceptible of practical application by the lawyer alone.

Participation in joint study groups, in committees to review new legislation, and particularly in the Foundation's tax conferences, brings lawyers and accountants together in the study of questions in which each contributes and gains a better understanding of respective points of view and of the problems before them.

The personal associations so developed between members from different cities and Provinces cut across the limits of local and competitive practice, and make for a wider range of vision and exchange of experience, as well as for easier relations in individual cases of joint clients, than is possible between relative strangers.

The work of the Foundation's conferences and committees acquaints the participants with underlying concepts of taxation which are an advantageous background to the treatment of the particular problems that confront the individual practitioner from day to day. Most professional men are so occupied with the daily routine of office work that they have no opportunity to broaden their perspective. The Foundation's publications as well as its meetings help to correct this deficiency.

All these consequences will lead in turn to a greater degree of certainty and uniformity in the professional

handling of clients' affairs and will, by the same token, contribute to more uniformity in the administrative practices of the Taxation Division throughout the country.

Benefits to Corporations and Individuals

Perhaps the principal beneficiaries of the Canadian Tax Foundation, whether they know anything about it or not, are all the people in the country who are aware of the pressure of taxation from every direction but have no means of viewing the system as a whole or of knowing whether it is working fairly and efficiently.

The Foundation's work has a cumulative influence toward coherence and coordination of the tax system on a long-term view of its development, so that corporate and individual taxpayers may look forward to a more consistent development of taxation principles rather than a succession of improvised expedients.

Having regard to the way in which tax legislation comes into existence, the language in which much of it has to be written, and the diffuse complexity of the results, the very existence of the Tax Foundation breaks the closed circle of delegated authority and administrative initiative which tax laws always tend to produce, and introduces an external influence directly reflecting the experience of taxpayers themselves.

The practical results of the work of the Tax Foundation, young as it is, are already beginning to be felt. Since it started four years ago it has made representations to the Minister of Finance with regard to anomalies, hardships and inequities in current legislation, which have been well received and reasonably successful.

The Foundation's membership represents a wide cross-section of experience of taxpayers' problems. Its representations therefore have a solid claim to the consideration of the tax authorities which the latter recognize. The Minister of Finance acknowledged this in Parliament last year, when he submitted the Bill to amend the *Income Tax Act* for second reading and described the Foundation's suggestions in regard to it as "very helpful and constructive".

The following are some examples of what has been done in this way. In the spring of 1947, when the Government's Drafting Committee began work on the revision of the *Income War Tax Act,* the Foundation, being newly established, offered to organize a representative committee of lawyers and accountants to consider questions of difficulty on which an outside opinion would be constructive. The Government accepted this offer, and a list of questions referred to the Foundation was studied at a series of meetings by a joint Montreal-Toronto group. Recommendations were submitted to the Drafting Committee and taken into consideration at an early stage of its work. In December of the same year, the Foundation's first tax conference was organized to review the Bill which embodied the draft revision of the Act. The resulting report was forwarded to the Government and was extensively used by business and professional organizations across the country in preparing submissions which the Government had invited.

Private Companies

The legislation respecting "Private Companies", enacted last year under Part IA and the related sections of the *Income Tax Act,* was to some extent anticipated at the Foundation's second tax conference, held in November, 1948, when one of the sections dealt with this question. A review of the

problems brought to light by the Ives Commission, but not disposed of by the resulting legislation under Part XVIII of the old Act, produced several alternative proposals, one of which substantially expressed the principle of the legislation now enacted, being stated in the conference report as follows:

> Introduction of a special provision which would permit closely-held companies to capitalize a stated proportion of earned surplus, going perhaps as high as 50 per cent, on payment of a special corporate tax on the amount of surplus so treated, such amount then becoming available for distribution free of tax to shareholders at any time thereafter.

Returning to the same question at the third tax conference in 1949, the staff of the Foundation submitted a plan of amendment directed to the problems of "double taxation" in general and of "private companies" in particular which developed the idea of tax-paid capitalization in concrete terms.

Recognizing that the new legislation follows much careful study of this matter by the tax authorities, it is not suggested that the Foundation is entitled to take all the credit for it. But it can be said that the Foundation's work, initiated from outside on the strength of the experience of its members, helped both to secure recognition of the post-war aspects of the problem and to develop the method of treatment adopted. To conclude this reference, it should be added that one of the six round table groups at the fourth tax conference, held last December, was set up to review the operation of this legislation to date. This investigation disclosed a consensus of opinion on several points of difficulty which are being brought to the Government's attention, and which were also observed by representatives of the Government departments who attended the meeting.

A third instance of the Foundation's attention to current legislation, applied in a different way, should also be mentioned. Complaints are often heard that after new tax legislation has been introduced in Parliament it does not receive sufficient critical examination before it is enacted. Part of the difficulty is due to the complexity and technical character of the legislation itself which make it unsuitable material for parliamentary debate; part of it is due to the principle of ministerial responsibility respecting revenue measures which governs the procedure; and part of it is due to the short time usually remaining after the general debate on the Budget Resolutions is concluded. Recognizing these factors, the Foundation last year initiated the practice of convening an expert committee to meet in Ottawa on the day that the amending Bill was delivered by the King's Printer, in order to study its provisions and submit immediate recommendations to the Department of Finance before second reading. It was to this action that the Minister referred in his acknowledgment quoted above. The Foundation intends to carry on this practice, and hopes to make it a recognized procedure unless the Government itself introduces a better one.

It was a coincidence that the Foundation was established just at the time when the Government was ready to undertake revision of the income tax statute after the last war. Today the review and revision of all tax laws is recognized to be a continuing process in which the initiative of the Government's experts calls for the participation of the taxpayer's experts at the same level of competence. Given the support it needs, the Foundation is

now in a position to carry out this indispensable function on a full-time basis.

Benefits to the Government

The value to the Government of an independent organization constituted and operating as described above needs no emphasis. It is recognized by the Government departments and is reflected in the Foundation's good relations with them.

Most civil servants who have responsibility in fields of administration directly affecting the personal interests of many people are aware of the limits of official wisdom and of the dangers of departmental isolation, even though their communications do not always show it. Tax administration and the determination of tax policy are particularly subject to these difficulties. The task of collecting revenue and of framing and enforcing complicated legislation for this purpose inevitably tends to develop a bias of attitude that is defensive as regards the Revenue and sometimes aggressive as regards the taxpayer. The Departments concerned cannot go out of their way to compensate this bias without prejudice to the performance of their duties. The compensating factor has to operate externally. This means that the actual existence of the Foundation is an advantage to the authorities regardless of agreement or disagreement on questions between them.

Much of the complexity of modern tax legislation is due to relieving provisions required in order to prevent inequitable results, but tax laws have to be intelligible as well as equitable. The difficulty of satisfying both requirements is well known. The tax authorities deserve help to succeed and encouragement to go on trying as well as criticism when they fail. Although an agreed principle may be clear, its expression in the words of a tax statute is often defective and always empirical. Those who draw up the legislation and administer it afterwards cannot judge its effect from the taxpayer's point of view unless they hear from his side, preferably through an independent agency which also has in view the coherence of the whole system. The Foundation, acting impartially without reference to special interests or political considerations, has come to be recognized as an agency of this character, which can operate outside the machinery of government but in conjunction with it.

On the other hand, the Foundation is not dependent on the Government's good pleasure. It enjoys no special privileges with any department and does not look for any. It stands on the same footing in this respect as any other organization representing the taxpayer's interests, the differences being that it represents no special class or group whatever, that taxation is its whole business, and that its sponsorship and its membership are unique credentials. Its constructive relations with the authorities rest on recognition of these facts, coupled with either side's appreciation of what the other has to do. The Foundation's standing with the Government will therefore continue to be determined by its performance. This depends in turn upon the support of the two sponsoring professions throughout the country.

Recommendations on the Income Tax Act

**Submitted to the Minister of Finance
by the Taxation Section of the Canadian
Bar Association and the Legislation Committee
of the Dominion Association of Chartered Accountants
February 23, 1951**

GROUP A

Recommended changes affecting taxation policy required for greater certainty and equity in the application of the specified provisions

1. The Income Tax Appeal Board (s. 76 et seq.)

The apparent tendencies to weaken the authority of the Board is a cause of concern and the following general considerations with regard to future policy are submitted:

RECOMMENDATION:

(a) A quorum of the Board should be not less than two of its members.

(b) The Board should be increased numerically accordingly.

(c) Responsibility for the Board should be vested in the Department of Justice rather than in the Department of National Revenue.

(d) The Board should be the final arbiter of all questions of fact which come before it and appeals from its judgments should lie only with respect to questions of law or of mixed law and fact and should be taken by way of stated case to the Exchequer Court.

Representatives of this Joint Committee would welcome an opportunity of discussing the whole situation with representatives of the Government.

2. Tax Evasion (ss. 125 and 126)

The strongest objection is raised to the continued presence of these two provisions in the tax law. Taxpayers should be entitled to believe and to act upon the belief that conduct which is not forbidden by law will not be penalized under either *ex post facto* legislation or by the exercise of arbitrary power by the Crown. These provisions and their predecessors in the *Income War Tax Act*, were, it is understood, enacted primarily to provide a means of countering evasive devices evolved by taxpayers to enable them to distribute free of tax undistributed surpluses of closely-held corporations. With the enactment last year of Part IA a solution for the problem of undistributed surpluses of closely-held companies has been found which has met with approval everywhere.

RECOMMENDATION: It is accordingly recommended that ss. 125 and 126 of the Act be repealed.

3. Related Companies; Companies Controlled by Persons not at Arm's Length (s. 36(4))

Under s. 36(4) one corporation is deemed to be related to another if at any time in the taxation year 70% or more of the capital stock of each of them is owned, *inter alia*, by persons not dealing with each other at arm's length. Under s. 127(5)(c) persons connected by blood relationship, marriage or adoption are deemed not to deal with each other at arm's length.

These two sections taken together would thus relate, for example, a Newfoundland shipping company to a British Columbia lumbering company if the controlling (70%) shareholders of each were connected by blood relationship, marriage or adoption, although the two individuals had no dealings with each other whatever.

RECOMMENDATION: It is therefore recommended that s. 127(5)(c) be made inapplicable to s. 36(4).

4. Lease-Option and Hire-Purchase Agreements (s. 18)

Under s. 18 lease-option and hire-purchase agreements and the like for the leasing or hir-

ing of property (other than farm land) shall be treated as agreements for sale in computing the income of the lessee, and the rent, etc., shall be deemed to be instalments on the price thereof, and for the purpose of capital cost allowances the lessee shall be deemed to have acquired the property at a capital cost equal to the price fixed by the contract or arrangement minus certain specified payments.

This provision gives rise to difficulty in that it is not always possible to say what is the "price fixed by the contract or arrangement". This is particularly so where the agreement contains options to re-purchase at different dates or where the contract calls for payments to be made which are not ascertainable in advance, e.g., annual municipal taxes.

RECOMMENDATION: It is recommended that the enactment be clarified to obviate this difficulty.

Bona Fide Transactions

In sweeping in all lease-option and hire-purchase contracts without exception (other than farm lands) s. 18 catches many *bona fide* transactions.

RECOMMENDATION: It is accordingly recommended that s. 18 be made applicable only to such portion of the annual payments as exceed a reasonable rent or hire.

5. Inventory Valuation (s. 14(2))

In defining the methods of inventory valuation which may be used by a taxpayer the Act and Part XVIII of the Regulations seek to enforce rigidity where there must in the nature of things be fluidity. Not only are the methods of valuation stipulated uncertain in meaning and application, but even if construed in the manner most in accord with business usages and accounting principles they may result in compelling many businesses to adopt accounting methods quite unsuited to their mode of operations. If the rules laid down are, as appears to be the case, designed to prevent tax-evading manipulations, then they are altogether unnecessary. For if the computation of income from a business is the profit therefrom (s. 4), which is to be ascertained in accordance with accounting and business usages, manipulations in the method of valuing inventory not having a sound reason in fact are not permitted by law.

RECOMMENDATION: It is accordingly recommended that s. 14(2) be repealed.

6. Non Arm's Length Transfers of Depreciable Property (ss. 17(2), 20(2) and 127(5)(c))

Under s. 20(2), where there is a non arm's length transfer of a depreciable asset the purchaser can only claim capital cost allowances on the basis of the actual price of the asset to him but is deemed to have also received the capital cost allowances taken by the vendor, and the allowances so deemed to have been received by him thus become potentially liable to be recaptured in his hands.

Under s. 17(2), however, where the sale was made at less than the fair market value the vendor actually receives less capital cost allowances than the amount deemed by s. 20(2) to have been allowed the purchaser, so that more capital cost allowances become potentially liable to recapture in the purchaser's hands than the gross amount actually allowed to vendor and purchaser combined.

The same result follows under s. 17(4) where there is a distribution of depreciable property by a corporation to its shareholders, at a price less than its fair market value, e.g., on a winding-up. In such a case the company will be chargeable on any additional amount that would have been recaptured had the sale been made at fair market value, while the same amount will be subject to recapture a second time in the hands of shareholders under s. 20(2).

Further, where a corporation sells or distributes property to a shareholder at less than fair market value, the amount of the benefit so conferred on the shareholder may become chargeable to him under s. 8(1)(c).

From an accounting point of view, it is often desirable that transfers of fixed assets between related companies should be recorded at book values (i.e., at the undepreciated capital cost of the assets) and reserves for depreciation be maintained. In view of the above provisions, however, this procedure is no longer practicable since if the book value is less than market value the difference is immediately recaptured in the hands of the vendor

and is subject to a second recapture in the hands of the transferee, and is perhaps also chargeable to him under s. 8(1)(c).

RECOMMENDATION: It is accordingly recommended that ss. 17 and 8(1)(c) should not be applicable in the case of transfers or distributions of depreciable property between related companies.

Transactions Between Relatives

A further injustice arises in connection with s. 20(2). Certain transactions between persons related by blood, marriage or adoption are conclusively presumed to be not at arm's length, although many such transactions are in fact conducted at arm's length. Under s. 20(2), however, where a sale of a depreciable asset is effected between relatives, the purchaser becomes potentially liable to pay tax on the recapture of capital cost allowances granted the vendor notwithstanding that the sale was at arm's length and that the same consequence would not ensue in the case of any other arm's length transaction.

RECOMMENDATION: It is accordingly recommended that *in any case* where property is actually transferred at fair market value, s. 20(2) be made inapplicable so that the position of the purchaser so far as ultimate recapture is concerned will not be affected by his relationship to the vendor.

7. Contributions to Approved Pension Plans (s. 11(1)(f) and (g))

Under these provisions only contributions by or in respect of employees to pension plans approved by the Minister are allowed as deductions to the employer and employees, while under s. 6(a)(iv) all pension benefits paid out, whether from an approved plan or otherwise, are taxable in the ordinary way as income of the year, and under s. 34 a single payment made to an employee on retirement out of a pension plan, whether approved or not, is chargeable either as income of the year of receipt or at the effective rate on his income for the last full year of employment. The deferment of tax on contributions to approved pension plans, confined as it is to employees, is justified by the principle that tax should only be imposed when the income emerges, which does not apply in the same degree to self-employed persons. Nevertheless an inadvertent discrimination arises by reason of the fact that the real owners of many incorporated enterprises are also employees thereof, and so are allowed the benefit of the provisions of s. 11(1)(f) and (g). Self-employed persons, such as professional men, who are precluded from incorporating their practices, are, however, unable to avail themselves of the same advantage, and of this denial they are particularly conscious, as the typical professional career brings them under heavy progressive taxation during the peak years of their career, while at the same time a professional practice by its nature does not create assets of significant disposal value on retirement from practice.

RECOMMENDATION: It is accordingly recommended that the approved pension plan classification be broadened to include the operation of pension trust plans to which persons other than employees may make contributions, subject to their complying with requisite conditions laid down by the Minister.

8. Liability to Pay Tax Although Appeal Outstanding (s. 48)

Under s. 48 tax as assessed, together with penalties and interest, must be paid within 30 days from the day of mailing the notice of assessment whether or not an objection to or an appeal from the assessment is outstanding. Under s. 48(2) the Minister has power to direct that all taxes, penalties, and interest be paid forthwith on assessment where he is of the opinion that the taxpayer is attempting to avoid payment of taxes. The latter provision would appear to accord the Minister complete power to prevent the evil which s. 48(1) was enacted to deal with, namely, the launching of an appeal purely as a means of delaying or evading payment of taxes, and accordingly s. 48(1) is unnecessary for that purpose. Unfortunately, however, s. 48(1) will also affect taxpayers who have a *bona fide* objection to an amount under assessment, and under s. 48(1) they are obliged to deposit the stake before the dispute is resolved.

RECOMMENDATION: It is accordingly recommended that the time limit for payment of tax, interest and penalties under s. 48(1)

be extended from 30 days to 60 days, i.e., the time within which a notice of objection must be served, and that where a notice of objection is served the taxpayer have the right to apply to the Income Tax Appeal Board for an order staying any proceedings under s. 48(1) until disposition of the appeal, such order to be within the discretion of the Board.

9. Consolidated Returns (s. 75)

Sound accounting and commercial practice requires the consolidation of the accounts of parent and subsidiary companies for the accurate reporting of income in many instances. This particularly applies where the situation is within the scope of subsec. (1) of this section. Furthermore, from the administration's point of view, consolidated returns simplify the administration of the Act by making it unnecessary to police inter-company transactions. Since the loss carry-over provisions have now been extended to cover a period of seven years, the filing of returns on a consolidated basis is not likely to give any taxpayer an unwarranted advantage, and thus the additional tax of 2% operates as a penalty and a deterrent to a desirable practice.

RECOMMENDATION: It is accordingly recommended that the 2% additional tax applicable to consolidated returns be removed.

10. Interest on Unpaid Taxes — Time Limit (s. 50(6))

Under s. 50(6) interest on unpaid taxes is not payable in respect of the period beginning one year after the filing date and ending 30 days from the day of mailing the notice of original assessment. The object of this provision was to relieve the taxpayer from the penalty otherwise resulting from a delay in assessment. It has now become the practice to issue a notice of assessment immediately after receipt of the taxpayer's return and subsequently, after fuller examination, to issue a revised notice if further tax is demanded. The result is that the taxpayer no longer enjoys the relief from interest which it is intended he should have.

RECOMMENDATION: It is accordingly recommended that the word "original" be deleted from the phrase "notice of original assessment" in s. 50(6), and that there be substituted "the assessment establishing the amount of unpaid taxes".

GROUP B

Recommendations not affecting taxation policy required to remove difficulties in the application of the law

11. Assessment of Business Losses (ss. 26(d), 42 (1) and (2))

Where a taxpayer sustains a loss which may be deducted from income of the previous year he will be deprived of the benefit thereof if the assessment for the previous year has been issued more than 60 days before the end of the loss year and no notice of objection has been filed. The Minister may re-assess under s. 42(4), and in this way permit the taxpayer to claim the loss, but the taxpayer cannot require this to be done as of right.

Moreover, it would seem desirable in the interests of persons carrying on business that they should be entitled to know the precise amount of a loss which will be recognized for purposes of the loss carry-over provisions of the Act.

RECOMMENDATION: It is accordingly recommended that where a taxpayer sustains a business loss in a taxation year he be permitted to file a "return of income" and have it verified or altered in the ordinary way and further that the taxpayer's right to carry back a loss be kept open.

12. Corporation Tax; Apportionment of $10,000 Between Related Companies (s. 36(2) and (3))

Under s. 36(2) and (3) where two or more companies are related to each other, only one of them is entitled to apply the lower rate of tax (15% instead of 38%) on the first $10,000 of its taxable income, and there is no provision permitting them to apportion the $10,000 between them. This has the unfortunate consequence that where

minority shareholders are involved the controlling shareholders of the related companies are forced to confer an advantage on the shareholders of one company to the disadvantage of the minority shareholders in the other or others. It also works hardship where each of the related companies has an income of less than $10,000.

RECOMMENDATION: It is accordingly recommended that provision be made to enable the $10,000 subject to the lower rate to be apportioned between related companies as agreed by the companies each year.

13. Terminal Allowance (Reg. 1100(3))

Under reg. 1100(3) where a taxpayer disposes of depreciable property he is entitled to a deduction in that year of the balance of the undepreciated cost of property of that class at the expiration of the year *provided he has no property of that class at the end of the year.* In effect, therefore, if these conditions are met, he can deduct in that year the amount of the net loss sustained by him on all the dispositions of property of that class. In any other case the amount of loss sustained on the disposition of an asset is merely added to the undepreciated capital cost and becomes subject to the applicable percentage deduction allowed by reg. 1100(1). This situation discriminates particularly against a taxpayer who discontinues business and sells all his assets. If the assets are finally disposed of in the year following discontinuance presumably the allowance under reg. 1100(3) could be claimed in that year, thereby creating a loss which could be carried back to the income of the preceding year under s. 26(1)(d), but if not sold until subsequently the taxpayer is deprived of any allowance. Moreover, if the income of the year of final disposal and of the preceding year are not sufficient in any case to cover the loss sustained on the disposition of depreciable property the taxpayer is deprived of the full benefit to which he is entitled. This will bear particularly hard, for instance, on a mining company which ceases operations when its ore is exhausted because of the necessity of disposing of all property in the class before being entitled to the allowance under reg. 1100(3).

RECOMMENDATION: It is therefore recommended that reg. 1100(3) be amended to allow the deduction at the end of a taxation year of the amount by which the undepreciated capital cost of property of any class exceeds the capital cost of the remaining property in that class.

14. Recaptured Capital Cost Allowance; Spreading of Tax (s. 34B)

Under s. 34B where capital cost allowance is recaptured by an individual the amount thereof, instead of being added to the individual's income for the year of receipt and thus charged to tax at the highest graduated rate applicable to the individual's income for that year, may be added to his income of preceding years and charged at the rates applicable in such case. With the introduction of differentiated rates for corporations the effective corporation tax rate may fluctuate considerably from year to year, and the reasons which warrant the right of election under s. 34 now apply with almost equal force to corporations.

RECOMMENDATION: It is recommended therefore that s. 34B be amended to extend the right of election thereunder to all persons.

15. Tax Credit for Taxable Dividends From Personal Corporations (s. 35(1))

Under s. 35(1) an individual is entitled to a tax credit of 10% of the amount of dividends received by him from corporations resident in Canada that were not, by virtue of a statutory provision, exempt from tax for the year. If a corporation is a personal corporation in a particular year and so is exempt from tax under s. 61 the shareholder is thus disentitled to a tax credit. The corporation may, however, pay dividends in that year which derive from profits of preceding years in which the corporation was not a personal corporation. Thus the shareholder is deprived of any tax relief on dividends paid out of profits which bore the full corporation tax rate.

RECOMMENDATION: It is accordingly recommended that the 10% tax credit on the amount of dividends received from taxable corporations under s. 35(1) be extended to dividends from a personal corporation to

the extent that s. 61(6A) requires their inclusion in computing the income of the shareholder.

16. Continuance of 4% Tax on Redemption of Stock Issued Against Capitalized Surplus (s. 130(2))

S. 130(2) gives continuing effect to s. 19A of the *Income War Tax Act*. This latter section, which was enacted by 1932-33, c. 14, s. 9, provides that where the assets of a company having on hand undistributed income at the end of its 1929 taxation period are transferred to another company either by sale of the assets or of its shareholders' shares, the redemption of any redeemable instruments issued by the latter company shall give rise to a 4% tax on the company on the amount of such pre-1930 undistributed income which was absorbed by such instruments. This provision was apparently corollary to the amendment to s. 19 enacted by 1930, c. 24, s. 4, repealed by 1934, c. 55, s. 10, which permitted a company to dispose of its undistributed income on hand prior to the commencement of its 1930 taxation period by means of a winding-up, discontinuance, or reorganization of its business, free of any tax liability to the recipients.

The purpose of s. 19A, at least so it would seem, was to withdraw this exemption to the extent of a 4% tax. The enactment is not in terms, however, restricted to redemptions of securities issued for undistributed income distributed during the period of exemption and to that extent constitutes an additional tax to the normal tax imposed.

It is considered that this additional tax ought only to apply to the redemption of instruments issued prior to 1934 which have not yet been redeemed.

RECOMMENDATION: It is therefore recommended that s. 130 of the *Income Tax Act* be amended to restrict s. 19A of the *Income War Tax Act* to the redemption of securities outstanding prior to the commencement of the redeeming company's 1949 taxation year.

17. Foreign Business Corporations (s. 64)

Under s. 64 a foreign business corporation must file a return and pay the prescribed fee within 120 days of the end of the year on penalty of losing its exemption from tax. The penalty is out of all proportion to the default, and, moreover, there is no apparent reason why the time limit should be 120 days for such corporations when it is six months for other corporations.

RECOMMENDATION: It is accordingly recommended that the time limit for filing the return of a foreign business corporation under s. 64(2)(b) be extended to six months, and that the loss of exemption penalty not apply where the corporation establishes reasonable cause for delay.

18. Penalty for Failure to File Information Returns (T.D. 1's)(s. 117)

It seems apparent that the reference in s. 117 to s. 112(2) was inserted by error.

RECOMMENDATION: It is accordingly recommended that s. 117 be amended by deleting the reference to s. 112(2).

19. Losses of Personal Corporations (s. 61)

Under s. 61 the whole *income* of a personal corporation is deemed to be distributed to its shareholders each year and is chargeable to the shareholders. Because it is the "income" of the personal corporation which is charged to the shareholders the latter cannot claim a loss in any year in which the corporation sustains a loss, since in such a year the corporation has no income and cannot carry the loss over to the preceding or subsequent year under s. 26(d). This means that in the case of such personal corporations as rental companies, the shareholders may be charged to tax over a period of years on a greater amount than the corporation's actual income for that period.

RECOMMENDATION: It is accordingly recommended that the provisions of s. 26(d) be made applicable to personal corporations.

GROUP C

Recommended major changes in taxation policy required in the public interest

20. Husband and Wife (s. 21)

Transfer of Property

Under s. 21(1) where one spouse transfers property to the other spouse the income therefrom or from property substituted therefor shall be deemed to be the income of the transferor and not of the transferee.

RECOMMENDATION: It is recommended that s. 21(1) be amended by addition of the following clause: *"unless there has been consideration equal to the fair market value of such property".*

Employment of Spouse

Under s. 21(2) and (3) remuneration paid one spouse as an employee of the other or as an employee of a partnership in which the other spouse is a partner is deemed to be income of the principal. These provisions are designed to prevent tax evasion, but they also sweep up many cases of *bona fide* employment. S. 12(2), which prohibits the deduction of expenses not reasonable in the circumstances, would appear to afford every needed safeguard to the Revenue and at the same time permit equitable treatment of *bona fide* cases.

RECOMMENDATION: It is accordingly recommended that s. 21(2) and (3) be repealed, or at least that the following clause be added to both s. 21(2) and (3): *"unless actual services have been rendered at a reasonable rate of remuneration".*

Partnerships of Husband and Wife

Under s. 21(4) where a husband and wife were partners in a business the Minister has discretion to impute the income of either spouse from the business to the other spouse.

RECOMMENDATION: It is recommended that the following clause be added to s. 21(4): *"unless there exists between the husband and wife a bona fide business relationship".*

21. Income From Chief Source (s. 13)

Under s. 13 the income of a person from his chief source of income cannot be reduced by losses sustained by him in other activities unless the Minister exercises a discretionary power under s. 13(2). This will result in a person being subject to tax on something more than his real income, subject to a discretion in the Minister to relieve him from the added burden. If there is any sound reason for disallowing deductions for losses sustained the ground for such disallowance should be spelled out in explicit language in the statute.

RECOMMENDATION: It is accordingly recommended that s. 13 be repealed.

22. Certain Payments Out of Pension Plans (s. 6(a)(iv) and s. 34)

Instances occur in which superannuation and pension payments referred to in s. 6(a)(iv) and s. 34 are in part a return of contributions made by an employee in respect of which no tax deduction had been allowed. To that extent such benefits should not be regarded as income.

RECOMMENDATION: It is recommended that such payments be chargeable to tax only to the extent that they exceed the non-exempt contributions made thereto by the employee.

23. Single Payments Out of Pension Plans: Spreading of Tax (s. 34)

S. 34 affords a measure of relief to a recipient of certain single payments which would otherwise attract tax at an unreasonably high rate.

RECOMMENDATION: It is recommended that such relief be extended by granting the recipient a further option to elect to pay tax on the taxable portion as if that amount had been received in equal portions in the year of receipt and the four preceding years.

24. Income from Office or Employment (s. 5)

Save in one or two exceptional cases an employed person is taxed on the gross amount of his remuneration though this may not in fact be his true income from the employment.

RECOMMENDATION: It is accordingly recommended that in computing income from

an office or employment the expenses necessarily incurred in the performance of the employment should be deductible.

25. Limitation Period for Re-assessments (s. 42(4))

Under s. 42(4)(b) the Minister may re-assess within 6 years from the day of the *original* assessment in cases where fraud or misrepresentation is not alleged.

RECOMMENDATION: It is recommended that the limitation period of 6 years under s. 42(4) commence to run not from the date of the original assessment but from the date on which the return should have been filed or the actual date of filing, whichever is later.

26. Combined Payments of Income and Capital (s. 7)

S. 7 permits a payment made under a contract or other arrangement to be severed for assessment purposes and the interest or income portion thereof to be included in computing the recipient's income. There is, however, no parallel provision permitting the payor a corresponding deduction in an appropriate case.

RECOMMENDATION: It is recommended that whenever a portion of a payment is deemed to be interest or income of the recipient under s. 7 it also be deemed to be a payment of interest or of an income nature by the payor so as to be deductible by him in an appropriate case.

27. Reserves (s. 12(1)(e))

In order to arrive at the proper figure for the profit of any enterprise provision must be made for losses on current transactions which experience has established will be incurred in the future. Clearly a computation of profit on a series of transactions which takes no account of rebates or losses which, though not yet incurred, will certainly be incurred, is inaccurate, and to that extent the taxpayer suffers an excessive tax burden which can in some cases be serious since the loss carry-over will not absorb every loss.

RECOMMENDATION: It is accordingly recommended that reserves should be permitted to provide for costs and expenses which are an ordinary risk of business already transacted and which would be deductible as an expense if incurred in the taxation period to the extent that experience has shown them to be reasonable and proper. Those reserves existing immediately before the change might be allowed in the year following or otherwise spread over a short period of years.

Negotiable Paper

Where a taxpayer receives negotiable paper in the course of business which he discounts at a bank the bank becomes the holder in due course of the paper subject to a right of recourse against the taxpayer if the paper becomes uncollectible. The taxpayer is thus subject to a contingent liability on discounted paper against which sound business and accounting practice may call for the setting up of a reserve.

RECOMMENDATION: It is accordingly recommended that the Act be amended to permit the setting up of a reserve in respect of a taxpayer's contingent liability on negotiable instruments received by him in the course of his business.

28. Loans to Shareholders (s. 8(2))

S. 8(2) provides that a loan made by a corporation to a shareholder shall be deemed to have been received by the shareholder as a dividend in the year in which it is made, save in certain cases. There seems to be no valid reason for so treating loans where no element of tax avoidance is involved, i.e., loans which are repaid within a short time.

RECOMMENDATION: It is recommended that s. 8(2) be applicable only to the balance of a loan which is not repaid by the end of the taxation year following that in which the loan was made.

GROUP D

Recommended changes in the administration of the Act and in the Income Tax Regulations which do not call for changes in the Act

29. Assessments Where Policy Changed

RECOMMENDATION: It is recommended that where a taxpayer acted in good faith in computing his income for a year the Minister refrain from assessing him to tax on the basis of a change in tax policy in a subsequent year.

30. Capital Cost Allowance for Timber Limits (s. 11(1)(a) and (b))

S. 11(1)(a) authorizes deductions in respect of the capital cost of "property" and s. 11(1)(b) authorizes allowances in respect of oil or gas wells, mines and timber limits. While the allowances under s. 11(1)(a) are subject to recapture under s. 20, the allowances under s. 11(1)(b) are not. From the language used in s. 11(1)(a) and 11(1)(b) it seems clear that, when s. 20 was enacted, there was not only no hint that it would apply to timber depletion but a strong indication that it would not. Despite this the Income Tax Regulations grant timber depletion allowances under s. 11(1)(a) and thus make them subject to recapture. To this extent the regulations result in extending s. 20 to matters which Parliament obviously did not intend to be covered thereby.

RECOMMENDATION: It is recommended that the capital cost allowances for timber limits be granted under authority of s. 11(1)(b) so that s. 20 will not be applicable thereto.

31. Bad Debts and Reserve for Doubtful Debts (s. 11(1)(d) and (e))

Under s. 4 the income from a business is declared to be the profit therefrom for the year, which in the absence of any provision in the Act to the contrary, would, in accordance with business and accounting usages, permit the deduction of bad debts and the setting up of a reserve for doubtful debts. The Act, however, contains specific provisions on both of these subjects. S. 11 permits the deduction of (a) a reasonable reserve for doubtful debts that have been included in computing the taxpayer's income, (b) a reasonable reserve for doubtful debts arising from loans made in the ordinary course of business by a taxpayer part of whose ordinary business was the lending of money and (c) of debts that are established to have become bad in the year.

Difficulties have arisen in the administration of these provisions because of varying interpretations of the provisions by the assessing officers.

(1) Where a trader supplies goods to a customer over a period of time and maintains a continuing account, payments made by the customer are not regarded by the supplier as attributable to any particular sale but to the account as a whole. There is thus always a continuing debt against which sound accounting practice may require a reserve. Some officials erroneously take the stand that no reserve is allowable in such a case because there is no specific amount to which the taxpayer can point as being doubtful of collection.

(2) Where a trader deals with a large number of customers he frequently does not have sufficient information as to the credit record of all his debtors to be able to determine with any degree of assurance which specific accounts are doubtful, but his experience with similar accounts has nevertheless established that a certain percentage of amounts payable will not be collected. In such case it is sound accounting and business practice to set up a reserve for doubtful debts, and there seems no reason to question that s. 11(1)(d) permits this to be done. However, this is apparently not the view of some officials.

(3) In the case of processors of certain types of primary products, it is common commercial practice for the processor to finance the primary producer by advances at the commencement of the season which advances are to be repaid by deliveries of the product. This practice prevails in, e.g., the fishery trade, the wood pulp and lumber trades, the fur trade, and others. However some officials erroneously refuse to allow

reasonable reserves and write-offs with respect to such advances on the narrow ground that the lending of money is not part of the ordinary business of the taxpayer because it is not specifically referred to in its letters patent or other charter. (Such debts have, of course, not been included in income as they do not arise from sales.)

RECOMMENDATION: It is recommended that these provisions be administered uniformly and in accordance with the principles adumbrated above.

Note: See also recommendation in respect of negotiable paper.

32. Time for Issue of Assessment Notices (s. 42(1), (2) and (4))

While s. 42(1) and (2) provides for the issue of an assessment notice only after the examination of the return, it has become the practice in the past two years for assessment notices to be issued immediately upon receipt of the return and without real examination; then at a subsequent time, after the return has been examined and found wanting, a revised assessment notice is issued. This causes considerable and, it is thought, quite justifiable, annoyance to a taxpayer who, having made a *bona fide* return and received a confirmatory assessment notice, subsequently receives a revised notice assessing a greater amount to tax.

RECOMMENDATION: It is accordingly recommended that first assessment notices should clearly state that the taxpayer's return is subject to further review and re-assessment.

33. Corporations, Pro-Ration of Reduced Rates (s.36(2) and (3))

Some officials erroneously hold that the first $10,000 of corporation income to which the lower rate is applicable should be prorated where the fiscal period of the corporation is less than 12 months.

RECOMMENDATION: It is recommended that the application of the reduced rate be administered in accordance with the Act.

34. Contents of Notices of Assessment (s. 42(2))

Most taxpayers lack specific knowledge in respect to the right of appeal from an income tax assessment.

RECOMMENDATION: It is accordingly recommended that the notice of assessment should provide adequate information respecting the taxpayer's right of appeal against his assessment.

35. Capital Cost Allowance for Leaseholds (Regs. 1100(1)(b) and 1100(6))

Under regs. 1100(1)(b) and 1100(6) the capital cost allowance in respect of long-term leasehold property may be less than the allowance permitted under reg. 1100(1)(a) which would otherwise be applicable.

RECOMMENDATION: It is therefore recommended that a taxpayer to whom reg. 1100(1)(b) applies have the option of claiming capital cost allowances either under reg. 1100(1)(a) or 1100(1)(b).

36. Leaseholds, Patents, Franchises, Concessions, Licences, Timber Removing Equipment (Reg. 1100(1)(b))

Under reg. 1100(1)(b) the capital cost allowance for leasehold property is computed separately in respect of each property and on a straight-line basis, although all of such leasehold property constitutes one class under class 13 of Schedule B. The same is true of patents, franchises, concessions, and licences described in class 14, and timber removing equipment described in class 15 of Schedule B. For recapture purposes and terminal allowance, however, all of a taxpayer's property in any of the above classes is treated as a class under s. 20(1) and reg. 1100(3).

RECOMMENDATION: It is recommended that each item of property described in classes 13, 14 and 15 of Schedule B constitute a separate class so that the recapture and terminal provisions, as well as the percentage deduction provisions, apply to each property separately.

37. Capital Cost Allowance for Lease-Option and Hire-Purchase Agreements (Reg. 1100(4))

S. 18 requires that lease-option agreements be treated as agreements for sale in computing the taxable income of the lessee. In some cases the maximum capital cost allowances permitted under the regulations are greater than the rental payments called for

by the contract. If the lessee is a corporation there is no means by which it can record the larger amount in its books, with the result that reg. 1100(4) will operate to deprive it of a portion of the capital cost allowance to which it is entitled.

RECOMMENDATION: It is accordingly recommended that for such cases the maximum capital cost allowances for any taxation year be calculated as the difference between the aggregate of the rent paid under the contract to the end of that taxation year and the aggregate of the capital cost allowances which have been allowed to the end of the preceding year.

GROUP E

Recommended changes in the recent enactments affecting the undistributed income of private companies and related matters

38. Private Companies, Undistributed Income, etc. (ss. 73, 73A, 27, 95 and 95A)

On these matters this Joint Committee wholly endorses the written statement and recommendations made by The Canadian Tax Foundation, (see pp. 152-7 of this issue) and which is being submitted independently. The recommendations so endorsed are in brief:

1(1) Definition of "undistributed income on hand"

RECOMMENDATION: It is recommended that the formula expressed in s. 73A(1)(a) be amended to the following effect:

1. *Terminal point*

"Undistributed income on hand" of a corporation *at any time in* a specified taxation year means the aggregate of the incomes of the corporation for the taxation years beginning .... and ending with *the last taxation year that terminated before that time or with the specified year if it terminates at that time* minus the aggregate of ....etc., etc.

2. *Deduction of dividends* — (Sub-paras. (v) and (vi))

The aggregate of deductible amounts to include without distinction all deemed dividends incurred and all eligible cash dividends paid *previous to the time in the specified year when determination of "undistributed income on hand" is required* for the purpose of the Act.

1(2) Treatment of "tax-paid undistributed income" in the hands of a corporate shareholder

RECOMMENDATION: It is recommended that the Act be amended to provide that any dividend deemed to have been received by a corporation from any other corporation shall be added to the tax-paid undistributed income of the recipient corporation to the extent that such dividend represents a portion of the tax-paid undistributed income of the payor corporation.

1(3) Computation on the basis of a notional winding-up of "shareholder's portion" under s. 73A(1)(c) and of "receiving corporation's portion" under s. 27(1F)

RECOMMENDATION: It is recommended that the prescribed manner of computing a shareholder's portion of undistributed income under s. 73A(1)(c) and of a recipient corporation's portion of a controlled corporation's earnings for a control period under s. 27(1F) be abandoned, and that it be provided, instead, that the portion to be attributed to a shareholder in either case shall be the portion distributable to him by way of dividend at the time when the taxable transaction takes place.

2(2) Payment of tax by instalments respecting undistributed income on hand at the end of the 1949 taxation year

RECOMMENDATION: It is recommended that eligible companies be granted an option to pay the special tax on pre-1950 undistributed income by instalments.

2(3) Adjustment respecting subsequent reduction or impairment of "1949 surplus" in case of postponed elections under s. 95A(1)

RECOMMENDATION: It is recommended that a company whose undistributed income on hand at the end of 1949 has been reduced before an election is made under s. 95(A)(1), be entitled to elect and pay the special tax on the amount of undistributed income on hand at the end of the taxation year preceding the date of election.

ADDITIONAL RECOMMENDATIONS

This Joint Committee, in addition to endorsing the above recommendations of The Canadian Tax Foundation, makes the following recommendations on its own account:

39. "Undistributed Income on Hand", Earnings Prior to January 1, 1917 (s. 73A)

S. 73A provides that the undistributed income on hand of a corporation shall include the whole of the income for its 1917 taxation year, which may have commenced in 1916. However, during the years 1917 to 1920 companies were allowed to (and many companies did) pay as tax-free dividends all of their earnings up to December 31, 1916 including the earnings of broken periods up to that date. These dividends may not be deducted in computing undistributed income on hand. As a result some companies find that they are compelled to include in undistributed income amounts earned in a 1917 fiscal year which were consciously paid out as dividends and are not now on hand. They are thus faced or will ultimately be faced under either s. 73 or s. 95A with liability to pay tax on an equivalent amount of capital or capital profits.

RECOMMENDATION: It is recommended that the definition in s. 73A(1)(a) be amended to permit the deduction of all exempt dividends paid out of non-taxed income earned in the 1917 taxation year.

40. Different Fiscal Years of Parent and Subsidiary Corporations (s. 73A)

Where owing to a difference in the fiscal period of a parent corporation and a subsidiary, a dividend is paid by the latter in its 1949 fiscal year but received by the former in its 1950 taxation year, undistributed income of the subsidiary at the end of its 1949 period is reduced by the amount of such dividend (s. 73A(vi)), but the undistributed income on hand of the parent company is not increased by the same amount until its 1950 fiscal period (s. 73A(1)). The subsidiary, therefore, cannot elect to pay the special tax on such amount under s. 95A(1) and the parent company can only elect to do so under s. 95A(2), i.e., by distributing dividends to its shareholders in an equal amount. This discriminates against the parent company merely because of the difference in the fiscal year of its subsidiary, a difference which may be due to causes beyond its control.

RECOMMENDATION: It is therefore recommended that where both a parent corporation and a subsidiary controlled corporation have elected under Part IA, the parent corporation have the option to include a dividend paid in the circumstances related above in computing its undistributed income on hand at the end of its 1949 taxation year.

41. Dividends Declared and Paid After 1949 (s. 95A(2)(b))

Elections under s. 95A(2)(b) to pay the special 15% tax are limited to an amount equal to the amount of dividends declared and paid by the company in 1950 and subsequent years. There seems no reason to exclude dividends merely because they were declared in 1949 or earlier, as such dividends are only deducted in determining undistributed income at the end of 1949 if they are paid by that date.

RECOMMENDATION: It is accordingly recommended that s. 95A(2)(b) be amended by deleting the words "declared and" from the phrase in subpara. (1), "the aggregate of the dividends *declared and* paid by it in the taxation years beginning with the 1950 taxation year".

APPENDIX

Memorandum of recommendations concerning Part IA of the Income Tax Act respecting private companies and controlled corporations submitted by The Canadian Tax Foundation

1. MECHANICAL DIFFICULTIES

1(1). Definition of "undistributed income on hand"

Our views and recommendations on this point were submitted to the Department of Finance in a letter addressed to Dr. A. K. Eaton dated May 31, 1950, when the legislation was so far advanced in Parliament that this feature could not receive further consideration before enactment. We were then assured that the matter would be brought to the Minister's attention this year.

Section 73, subject to the relieving operation of subsec. (4), provides that any of the corporate actions which it covers is deemed to constitute a taxable distribution to each shareholder depending upon "his portion of the undistributed income then on hand". Logically, the amount of the undistributed income should therefore be ascertainable when the action occurs. But the definition imposed by s. 73A(1)(a) requires the undistributed income (then) on hand to be computed as of the end of the taxation year in which the taxable transaction takes place. In the ordinary case of a going concern the amount in question is thus rendered unknown by definition at the time when it is held to attract tax.

For these reasons, as stated more fully in the letter referred to above, it is submitted that certainty, finality and convenience, as well as consistency of the statutory provisions, require the computation to be made on a basis which can be factually determined and verified before or at the time when s. 73 comes into play. In the case of a going concern the appropriate and only practicable basis, having regard to regular auditing procedure, is the company's financial statement as of the end of the last preceding taxation year. In a case of winding-up, on the other hand, the closing of the fiscal period automatically involves a final determination.

It is therefore recommended that the formula expressed in s. 73A(1)(a) be amended to the following effect:

1. Terminal Point

"Undistributed income on hand" of a corporation ***at any time in*** a specified taxation year means the aggregate of the incomes of the corporation for the taxation years beginning . . . . and ending with ***the last taxation year that terminated before that time or with the specified year if it terminates at that time*** minus the aggregate of . . . . . . etc., etc.

2. Deduction of dividends
—(Sub-paras. (v) and (vi))

The aggregate of deductible amounts to include without distinction all deemed dividends incurred and all eligible cash dividends paid ***previous to the time in the specified year when determination of "undistributed income on hand" is required*** for the purpose of the Act.

It is believed that definition in the foregoing terms will satisfy all the conditions contemplated by ss. 73 and 95A, as well as the objections to the present formula noted above, and we are not aware of any good reason why it should not be adopted.

If there is a deliberate reason for the basis of the present formula it has not been officially explained and is not understood by taxpayers. Suggestions are made that it is calculated to withhold some of the advantage of the new legislation in a case where a company anticipates substantial additional income, or that it is designed to block the assimilation of capital surplus to tax-paid un-

distributed income when the entire undistributed income is being capitalized. If these speculations are well founded, which we do not know, we would submit that neither restriction is called for in the context of the new legislation as a whole, and as to the second point in particular that it puts operating companies which cannot go through the procedure of winding-up at a disadvantage as compared with holding companies which can. In either case we think that a troublesome definition should not be employed to accomplish an indirect purpose when a straightforward definition is needed to carry out the essential purpose clearly.

1(2). Treatment of "tax-paid undistributed income" in the hands of a corporate shareholder

The report of a committee appointed by the Foundation to examine this question (see page 156) was submitted to the Departments of Finance and National Revenue on December 21, 1950, with the Foundation's recommendation, and has been acknowledged with assurance of consideration.

As stated in that report, the practical difficulty is the loss of identity in the hands of a parent company of a subsidiary company's tax-paid undistributed income transferred to it in whole or in part. Being excluded from the income of the parent company by s. 73(4) it becomes a capital item which cannot be assimilated into the latter's tax-paid undistributed income, nor made otherwise available to its shareholders without involving a notional distribution subject to further tax in their hands of its own undistributed income which includes its earnings to the end of the current fiscal year.

While amendment of the definition of "undistributed income on hand" as recommended above would relieve some of this difficulty, that is not the primary purpose of our recommendation 1(1). The anomaly of lost identity would still remain, involving awkward procedure and continued confusion of the underlying concept of tax-paid undistributed income and of the ultimate interest of the parent company's individual shareholders in regard to it.

We therefore believe that the operation and logical consistency of the legislation would be improved by amendment to preserve the identity of tax-paid undistributed income as it passes from one corporation to another as recommended in the report already submitted.

The question arises here whether this principle should be extended to all corporate shareholders as such, or whether its application should be confined to companies which are eligible to establish tax-paid undistributed income on their own account by election under Part IA. This question was discussed briefly at the last tax conference. There was unanimous opinion that a private company in receipt of tax-paid undistributed income from a subsidiary company should be put in the position recommended, as this is the situation in which the practical difficulty is encountered. The case of a public company so situated was regarded as a secondary question. If the same treatment is extended to distributions in the hands of corporate shareholders which are public companies there is an advantage of consistency in principle, and the consequences would appear to be largely academic and therefore unobjectionable. Provided this secondary question is not allowed to obstruct treatment of the primary problem, we would therefore favour adoption of the proposed amendment as a rule applicable to any corporate shareholder, as recommended in the memorandum already submitted. If this course is not acceptable, it is a simple matter to rephrase the draft of s. 73(4A) as originally suggested in our memorandum of December 21, 1950, in order to make it applicable to a receiving corporation "which may elect to pay tax under s. 95A".

1(3). Computation on the basis of a notional winding-up of "Shareholder's portion" under s. 73A(1)(c) and of "receiving corporation's portion" under s. 27(1F)

Under the above provisions as they now appear in the Act, (1) a "shareholder's portion" of a corporation's undistributed income, or tax-paid undistributed income, at any time, and (2) a "receiving corporation's portion" of a payer corporation's earnings for a "control period", are computed by reference to their right of participation in an assumed distribution on winding-up, with the further

assumption that the amount of undistributed earnings to be apportioned at the time constitutes the entire amount available for distribution on winding-up. The formula is expressed as follows:

(1) respecting a shareholder of a private company, (s. 73A(1)(c)):
"... the amount that would have been payable to him on the winding-up of the corporation at that time *if the amount to be distributed on the winding-up were the undistributed income on hand at that time, the portion of it, or the tax-paid undistributed income, as the case may be.*"

(2) respecting a "receiving corporation", (s. 27(1F)):
"... the amount that would have been payable to the receiving corporation on the winding-up of the payer corporation at that time *if the amount to be distributed on the winding-up were the amount of earnings that were so available for payment of dividends.*"

There is no problem where all the shares of a private company or controlled corporation are of one class. But where preferred shares or typical "Class A" shares are outstanding, having rights of participation in a distribution of assets on winding-up which differ from their rights of participation in a distribution of earnings by way of current dividend, the results of a notional distribution on the required assumptions may not correspond at all with the results ostensibly intended by the Act.

Examples of the anomalies which can be visualized here have undoubtedly come to the attention of the tax authorities since this legislation was enacted. It is suggested that the difficulty can best be avoided by abandoning the basis of a notional winding-up (although the previous application of this principle in the original s. 9 of the Act was not attended by the present limitation of the amount assumed to be available for distribution and was therefore more practicable), and by providing instead that the portion of undistributed income, etc., attributed to a shareholder or receiving corporation for the purposes in view is the portion distributable by way of dividend at the time when the taxable transaction takes place.

* * * *

The three points listed above cover the main difficulties encountered in the mechanical features of this legislation, as indicated to the Tax Foundation by the opinion of its members. The remedies proposed have the support of this opinion in principle, but our specific suggestions reflect the conclusions of working groups and the Foundation's staff on closer study. When the legislation was introduced last May we assumed that some clarification and adjustment would prove to be needed, and the foregoing submission represents our report of the first year's experience.

With regard to the points of principle which follow, the views of our members are less clearly defined. But we believe that these questions are due for consideration at this stage.

2. QUESTIONS OF PRINCIPLE

2(1). Companies eligible to elect under Part IA — Extension of defined class

When this legislation was introduced last May the Minister of Finance explained in reply to a question in Parliament that it was intended to apply for the time being to the same class of companies as was covered by Part XVIII of the old Act, to which the recommendations of the Ives Commission were also confined. The question of extending it to public companies was left for later decision in the light of experience.

We are not aware of a strong demand for its extension to public companies. Views on this question at the Fourth Tax Conference were divided, the balance of opinion being opposed in one group and in favour in the other. Those who opposed such extension argued that the legislation is directed to the disabilities affecting shareholders of closely-held companies which do not apply to owners of marketable shares, and that the essential object is to ensure its effective operation in the situation which it is designed to relieve. Views were also expressed that the form of the legislation is not well suited to a rule

affecting corporate enterprise generally, that its extension to all companies would give rise to confused expectations in the minds of shareholders leading to fruitless problems for management, and that the typical public company would remain outside its operation in any event. Such views will perhaps prevail more widely as time goes on and the emphasis of taxpayers' interest in the matter shifts from the advantage of the legislation as regards immediate release of accumulated surpluses, in the sense analogous to the relief previously provided by Part XVIII of the old Act, to its benefit as regards retention of corporate earnings free of accumulating tax penalty, in the sense of the Ives Commission's second recommendation.

On the other hand, extension to all companies would remove the need for an arbitrary limitation in the definition of "private company" and would eliminate the difficulty of border-line cases. It would thus obviate recourse in certain cases to the holding company device where this may be adopted in order to create the status of a "controlled corporation" within the meaning of s. 95A(3). As the latter cannot be arranged without concentration of controlling interest it is not necessarily inconsistent with the general intention of the legislation, but the procedure and resulting eligibility are artificial from the standpoint of the Act's provisions. The fact that the point of the legislation does not apply to most public companies does not affect the conclusion that its extension to all companies in principle would allow the widest straightforward application.

As an alternative to this course it is therefore suggested that consideration be given to broadening the present definition of "private company" to include (by way of alternative qualification) companies *the control of which is vested* in an appropriate maximum number of shareholders. We are not in a position to propose the appropriate maximum, which can best be indicated by the Department's experience and the information at its disposal. We have in mind the case of companies which would have qualified as "private companies" at a recent date but which have been converted into "public companies" by the action of shareholders who sold stock, retaining controlling interest, in order to secure funds for succession duty purposes. Such shareholders are now left at the disadvantage that a company which they still control no longer qualifies as a "private company" because the relief of the new legislation came later than they were prepared to wait, while they continue to be liable for an accumulating tax penalty with respect to its retained earnings.

2(2). Payment of tax by instalments respecting undistributed income on hand at the end of the 1949 taxation year

Part XVIII of the *Income War Tax Act* provided in s. 96(3) and (4) that a private company that had elected to pay tax thereunder could either make a single payment on or before December 31, 1946, or pay the tax in four equal annual instalments commencing on December 31, 1947, with annual interest at 4%, plus a penalty of 3% per annum on overdue instalments, and with the right of prepayment.

We recommend that a corresponding option should now be allowed with respect to tax payable on 1949 undistributed income under s. 95A(1). As there is no time limit on an election under the present legislation it would be appropriate to provide for four equal annual instalments commencing on the last day of a company's taxation year in which it exercises its election. The former provisions respecting annual interest, penalty and prepayment would again apply.

With respect to tax payable under s. 95A(2), on undistributed income earned after 1949, payment by instalments would offer little or no advantage in view of the progressive system of election already provided, and it might introduce some confusion.

We recommend further that tax-paid undistributed income as of 1949 should be proportioned to paid-up instalments of tax. This would be a departure from the scheme of the Part XVIII legislation, which required tax to be fully paid following an election before dividends thereunder qualified for exemption. The essential advantage of the present legislation, however, is the right of capitalization, which may or may not be followed by reduction and distribution. It is therefore consistent with the long-run objec-

tives that a private company having a large earned surplus on its books but a weak working capital position should be enabled to capitalize its surplus by degrees if it cannot afford to do so at once.

On the other hand, we do not suggest that there should be any change of the condition under subsection (2) of s. 95A that tax on 1949 surplus must be fully paid before undistributed income earned thereafter can be put on a tax-paid basis. Relaxation of this condition would in any case have little practical significance in the circumstances assumed.

The intention of this recommendation is simply that a company in the position described, which might be said to have a primary claim to the benefit of this legislation, should be at no avoidable disadvantage as compared with another company in a strong cash position. It appears that such a company should be given an opportunity to work its way without having to restrict normal dividends or arrange an unwelcome bank loan.

2(3). Adjustment respecting subsequent reduction or impairment of "1949 surplus" in case of postponed elections under s. 95A(1)

Again having regard to the future operation of this legislation, from the standpoint of corporate earnings reinvested rather than liberation of accumulated surplus, we recommend that companies which are not now in a position to concern themselves with the latter aspect and which, for this or any other reason, postpone an election to put their 1949 undistributed income on a tax-paid basis, should be given the right to base their "block" election under s. 95A(1) on undistributed income on hand at the end of their 1949 taxation year or undistributed income on hand at the end of the last taxation year that terminated before the date of election, whichever is less.

A provision to this effect would correspond with the option allowed under the Part XVIII legislation in s. 96(1) of the *Income War Tax Act*, with the difference that no terminal date should now be incorporated as none is provided under Part IA. Indeed the absence of any terminal date in the present legislation coupled with the fact that it has been framed with a view to its continuing operation in future, by contrast with Part XVIII which provided non-recurring treatment applicable to a past condition, makes the proposed option more advisable today. This consideration is reinforced by the prospect of uncertain, possibly difficult, business conditions for many small companies as the defence programme asserts increasing priorities on men and materials. It is not unrealistic to visualize circumstances in which rigid adherence to undistributed income on hand at the end of the 1949 taxation year as the basis of initial election would preclude a company in two or three years' time from any benefit of the new legislation by imposing too high a price.

If this view is accepted, it seems preferable to introduce the indicated amendment now rather than to wait until hardship has been experienced.

3. INCOME TAX ACT, PART 1A

Transfer of Tax-Paid Undistributed Income between Corporations

Report and Recommendations of a Committee appointed by the Canadian Tax Foundation to consider the above question, approved and submitted to the Departments of Finance and National Revenue — December 21, 1950

Your Committee held several meetings to consider the problem referred to in the memorandum of the director dated October 26, 1950, and has unanimously decided to recommend that the *Income Tax Act* be amended to provide that any dividend deemed to have been received by any corporation from any other corporation shall be added to the tax-paid undistributed income of the recipient corporation to the extent that such dividend represent a portion of the tax-paid undistributed income of the payer corporation. Suggested amendments to the statute to give effect to the recommendation of the Committee follow hereunder.

Your Committee supports the proposed amendments on the following grounds:

(1) The manifest intention of Parliament

in enacting Part IA of the *Income Tax Act* and the related amending sections was to make available to shareholders of private companies income accumulated to the end of 1949 and a portion of income accumulative thereafter without further tax after the payment of the 15% tax by the company.

(2) Where shares of a private company are held by another private company this purpose is defeated. In the case of a private company which controls another private company the tax-paid undistributed income of the latter loses its identity when capitalized and transferred to the parent company. It is excluded from income of the parent company under s. 73(4) and apparently must be considered as a special capital item. On the other hand, it cannot be made available to shareholders of the parent company without subjecting those shareholders to tax on any undistributed income of the parent company on hand at the time of distribution including all of its earnings for the fiscal year in which the distribution is made. For all practical purposes therefore the tax-paid undistributed income of a subsidiary becomes "frozen" in the hands of the parent company. The same result occurs in cases of the receipt of tax-paid undistributed income by a corporation where such receipt is from a private company in which a minority share interest is maintained.

(3) In the case of those private companies having wholly-owned subsidiaries, the problem is particularly acute. In this situation the shareholders of the parent company do not receive equal treatment with shareholders in a private company having no subsidiaries.

(4) In a situation analogous to that now under consideration, Part XVIII of *The Income War Tax Act* provided relief to the shareholders of the parent corporation.

(5) Your Committee submits that the logical solution is to preserve the identity of tax-paid undistributed income as it passes from one corporation to another. We suggest that the amendments proposed will correct the unfavourable treatment presently accorded to shareholders of private companies in the circumstances mentioned above and to that extent carry out the purpose of Parliament in enacting this remedial legislation.

The amendments proposed are as follows:

Repeal s. 73(4) and substitute therefor the following:

"(4) Where a dividend is under this section deemed to have been received by an individual in a taxation year, the amount thereof to be included in computing the individual's income for the year is the amount of the dividend minus the individual's portion of the payer corporation's tax-paid undistributed income as of the time the dividend is deemed to have been received.

"4(A) Where a dividend is under this section deemed to have been received by a corporation from another corporation having tax-paid undistributed income, there shall be added to the tax-paid undistributed income of the receiving corporation the lesser of the amount of the dividend or the receiving corporation's portion of the payer corporation's tax-paid undistributed income as of the time the dividend is deemed to have been received."

Insert in s. 73A(1)(b) immediately after the words "Income War Tax Act" in the first paragraph thereof, the following words:

". . . plus amounts added to the corporation's tax-paid undistributed income by reason of s. 73(4A)".

Amend s. 73A(1)(b) by inserting a new clause (ii) reading as follows and renumbering the present clause (ii) as (iii):

"(ii) all amounts deemed to have been received as dividends from the corporation by other corporations before that time and added to the tax-paid undistributed incomes of such other corporations by virture of s. 73(4A) of this Act, and . . . "

Repeal s. 27(1A)(e) and substitute therefor the following:

"(e) the amount of the designated surplus upon which tax had been paid by the payer corporation under Part IA before the dividend was paid and the amount of the designated surplus that had been added before that time to the tax-paid undistributed income of the payer corporation by virtue of s. 73(4A) of s. 73A(6) and . . . "

The foregoing amendments are suggested with the intention that they would apply as from the original effective date of the relative legislation.

Professional Notes

ALBERTA

Mr. S. E. Walls, C.A. announces the opening of an office for the practice of his profession in Banff.

* * *

Geo. A. Touche & Co., Chartered Accountants, announce the admission to partnership of Mr. John M. Read, C.A. in their Edmonton office.

BRITISH COLUMBIA

Gunderson, Stokes, Peers, Walton & Co., Chartered Accountants, 1016 Stock Exchange Bldg., Vancouver, announce the admission to partnership of Mr. P. N. Goode, C.A.

* * *

Buttar & Chiene, Chartered Accountants, 789 Pender St. W., Vancouver, announce the admission to partnership of Mr. Douglas M. Walker, C.A.

* * *

Geo. A. Touche & Co., Chartered Accountants, announce the admission to partnership in their Vancouver office of Mr. Alan W. Moreton, B.Com., C.A.

* * *

Mr. Frank N. Maas, C.A. announces the admission to partnership of Mr. K. S. Holman, C.A. Henceforth practice of the profession will be conducted under the firm name of Maas, Holman & Co., Chartered Accountants, with offices at 535 Homer St., Vancouver.

MANITOBA

Geo. A. Touche & Co., Chartered Accountants, announce that Mr. Thomas D. Poyntz, C.A., Winnipeg, has been admitted as a general partner in the firm.

ONTARIO

Mr. H. A. H. Mullin, C.A. announces the opening of an office for the practice of his profession at 414 New Wellington Bldg., 137 Wellington St. W., Toronto.

Mr. A. D. Magee, C.A. announces the admission to the partnership of Mr. Gordon W. Palin, C.A. Henceforth practice of the profession will be conducted under the firm name of Magee & Palin, Chartered Accountants, with offices at 217 Bay St., Toronto.

* * *

Wm. C. Benson & Co., Chartered Accountants, London, announce that Mr. F. L. Norwood, B.A., C.A. has been admitted to partnership in the firm.

* * *

Geo. A. Touche & Co., Chartered Accountants, announce the admission to partnership of Mr. James S. Innes, B.Com., C.A. and Mr. Charles E. Winters, C.A. in their Toronto office.

* * *

R. H. Bounsall & Co., Chartered Accountants, 14 Metcalfe St., Ottawa, announce the admission to partnership of Messrs. Arthur F. Davis, C.A. and Alec G. D. Bounsall, C.A.

Hamilton and District
Chartered Accountants' Association

The Hamilton and District Chartered Accountants' Association met on Friday evening, February 9, for dinner at the Officer's Club, following which various members of the association took part in a panel discussion on the subject "Determination of Business Income". The discussion was led by Messrs. C. K. MacGillivray, R. B. Taylor, A. W. Parish, and A. S. Hallamore. Following the speeches of the members of the panel, there was a lively discussion in which a large number of the members of the audience took part.

During the evening, prizes were presented to the students in this district who obtained the highest aggregate marks in the recent Institute examinations.

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A panel discussion on succession duties and related subjects was the feature of the monthly luncheon of the Regina Chartered Accountants Club held at the Assiniboia Club on Wednesday, February 14, 1951. The members of the panel, E. C. Leslie K.C., Duncan Grosh and Walter T. Read, C.A., outlined the various topics presented to the meeting for general discussion. Senior students were among those in attendance.

News of Our Members

Mr. Francis G. Winspear, C.A. (Alta.; B.C.), president of the Canadian Chamber of Commerce addressed the Ottawa Board of Trade on February 1 in the Chateau Laurier. He spoke on the place of businessmen in wartime.

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Mr. L. W. Cowley, C.A. (Ont.), has been appointed treasurer of Burns Bros. & Denton Ltd., Toronto.

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Mr. T. G. Dalglish, C.A. (Ont.) has been appointed a vice-president and secretary-treasurer of Harry E. Foster Advertising Ltd., Toronto.

* * *

Mr. G. H. Edwards, C.A. has been appointed superintendent of branches of Guaranty Trust Co. of Canada.

Professional Notes

ALBERTA

Mr. S. E. Walls, C.A. announces the opening of an office for the practice of his profession in Banff.

* * *

Geo. A. Touche & Co., Chartered Accountants, announce the admission to partnership of Mr. John M. Read, C.A. in their Edmonton office.

BRITISH COLUMBIA

Gunderson, Stokes, Peers, Walton & Co., Chartered Accountants, 1016 Stock Exchange Bldg., Vancouver, announce the admission to partnership of Mr. P. N. Goode, C.A.

* * *

Buttar & Chiene, Chartered Accountants, 789 Pender St. W., Vancouver, announce the admission to partnership of Mr. Douglas M. Walker, C.A.

* * *

Geo. A. Touche & Co., Chartered Accountants, announce the admission to partnership in their Vancouver office of Mr. Alan W. Moreton, B.Com., C.A.

* * *

Mr. Frank N. Maas, C.A. announces the admission to partnership of Mr. K. S. Holman, C.A. Henceforth practice of the profession will be conducted under the firm name of Maas, Holman & Co., Chartered Accountants, with offices at 535 Homer St., Vancouver.

MANITOBA

Geo. A. Touche & Co., Chartered Accountants, announce that Mr. Thomas D. Poyntz, C.A., Winnipeg, has been admitted as a general partner in the firm.

ONTARIO

Mr. H. A. H. Mullin, C.A. announces the opening of an office for the practice of his profession at 414 New Wellington Bldg., 137 Wellington St. W., Toronto.

Mr. A. D. Magee, C.A. announces the admission to the partnership of Mr. Gordon W. Palin, C.A. Henceforth practice of the profession will be conducted under the firm name of Magee & Palin, Chartered Accountants, with offices at 217 Bay St., Toronto.

* * *

Wm. C. Benson & Co., Chartered Accountants, London, announce that Mr. F. L. Norwood, B.A., C.A. has been admitted to partnership in the firm.

* * *

Geo. A. Touche & Co., Chartered Accountants, announce the admission to partnership of Mr. James S. Innes, B.Com., C.A. and Mr. Charles E. Winters, C.A. in their Toronto office.

* * *

R. H. Bounsall & Co., Chartered Accountants, 14 Metcalfe St., Ottawa, announce the admission to partnership of Messrs. Arthur F. Davis, C.A. and Alec G. D. Bounsall, C.A.

Hamilton and District
Chartered Accountants' Association

The Hamilton and District Chartered Accountants' Association met on Friday evening, February 9, for dinner at the Officer's Club, following which various members of the association took part in a panel discussion on the subject "Determination of Business Income". The discussion was led by Messrs. C. K. MacGillivray, R. B. Taylor, A. W. Parish, and A. S. Hallamore. Following the speeches of the members of the panel, there was a lively discussion in which a large number of the members of the audience took part.

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The Students' Department

J. E. Smyth, C.A., Editor

NOTES AND COMMENTS

ONE of the accounts which has been bounced around by irreverent students is Insurance. There are several ways of handling Insurance but the variety of legitimate treatments is not quite great enough to cover the efforts of the student who has been taught them all at once.

One of the possible treatments of Insurance is to debit the cost of the premium to an "Insurance" account and then at the end of the year to transfer to profit and loss only that portion of the cost which has expired. The balance left is then the unexpired portion. This takes only one account. It is also delightfully confusing. (Nobody is ever sure whether "Insurance" is an asset or an expense account.)

A second choice is to charge the cost of the premium to an asset account,

Dr. Insurance prepaid
    Cr. Vouchers payable.

At the end of the year the portion of cost associated with the revenue of the year is transferred to an expense account which is in turn closed out to profit and loss,

Dr. Insurance expense
    Cr. Insurance prepaid

and,

Dr. Profit and loss
    Cr. Insurance expense.

This method sets up a straw man ("Insurance expense") which we can immediately knock down again. It strikes some students as unproductive effort instead of the fun it really is.

The third choice, and the one we prefer just because we are most accustomed to it, is to charge the cost of the premium to an expense account at the outset,

Dr. Insurance expense
    Cr. Vouchers payable.

At the end of the year the unexpired portion is transferred to an asset account,

Dr. Prepaid expense
    Cr. Insurance expense.

The difficulty here, of course, is that a reversing entry is required at the beginning of the following period, which treatment is to most students a manoeuvre not more complicated than chess. (To prove the point, the reversing entry need not be made for another twenty-four hours.)

We conclude by observing that whatever method is chosen, Insurance gets a thorough roughing up in the process. It is rather like one of the unfortunate victims Procrustes forcibly fitted to his bed of fixed length.

(As the editor recalls the story of Procrustes, he was a giant who lived in a castle and extended a most genial invitation to travellers who requested overnight lodging. But his hospitality proved rather inflexible. Instead of adapting his accommoda-

tion to suit his guest, Procrustes would adapt his guest to suit the accommodation. He had only one guest bed and if his visitor proved too short for it, he was stretched until he fitted the bed. If he was too long for the bed, Procrustes found it necessary to amputate.)

(At this point the reader is supposed to picture Procrustes as an accountant and the bed as a business year and then turn to some other reading.)

PUZZLE

It is 360 miles from Toronto to Montreal. A train leaves Toronto for Montreal at the same time a train leaves Montreal for Toronto. The former train travels 60 miles per hour, the latter 40 miles per hour. Which of the two trains is the greater distance from Toronto when they meet? *(Contributed)*

ANSWER TO LAST MONTH'S PUZZLE

The empty bottle costs 10s. and the wine £8 10s., that is, £8 more than the bottle

Let $x =$ the cost of the bottle (in pounds)
Then $x + (x + 8) = 9$
$x = \frac{1}{2}$.

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants and reflect of course the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Intermediate Examination, October 1950

Accounting I, Question 1, (20 marks)

The following information relates to the A Co. Ltd.:

ANALYSIS OF SURPLUS

For the period 1 January 1948 to 31 December 1949

		Dr.	Cr.
1 January 1948	Balance		$202,400
15 January	Dividend	$100,000	
1 June	Additional income tax assessment for calendar years 1940-1941	8,700	
30 September	Adjustment of accounts receivable control (bringing control into agreement with detail)		100
15 October	Adjustment of buildings and machinery to appraised value (see appraisal of X Y and Z)		150,000
20 December	Christmas bonus for employees	15,300	
31 December	Profit for year		230,000
15 January 1949	Dividend	100,000	
1 March	Adjustment of value of securities owned to market		65,100

30 June	Loss on sale of securities (all holdings sold)	76,300	
31 December	Reduction of inventory to market	60,700	
	D. & Co.—bankrupt—account uncollectible	8,300	
	Profit for year		102,000
31 December 1949	Balance	380,300	
		$749,600	$749,600

Depreciation on buildings and equipment has been provided on a percentage of sales, and it is now decided to adjust the accounts to a straight line basis. The following reflects the depreciation charged and the depreciation on a straight line basis at rates applicable to the A Co. Ltd.

Year	Recorded in Accounts	On Straight Line Basis
Prior to 1948	$201,700	$197,600
1948	30,500	40,100
1949	26,700	51,000
	$258,900	$288,700

From time to time material has been included in the year end inventories for which the liability was not recorded until the following fiscal period and vice versa as follows:

	Materials in inventory for which liability not recorded	Materials omitted from inventory but liability recorded
31 December 1947	$10,300	$3,700
1948	15,700	
1949		4,800
	$26,000	$8,500

Interest accrued and interest prepaid on loans due to the company have not been set up on the books as follows:

	Interest Accrued	Interest Prepaid
31 December 1947	$	$500
1948	1,200	
1949	4,300	
	$5,500	$500

Bad debts and bad debt recoveries have not been handled on a reserve basis, and it is now decided to set up the proper reserve. The following analysis shows the transactions:

Year ending 31 December	Accounts receivable written off and charged to Profit & Loss	Bad Debt recoveries credited to Profit & Loss	Charges to Expense which would be required on a reserve basis
Balance 1947			$19,300
1948	$6,200	$500	6,800
1949	4,700	200	8,600
	$10,900	$700	$34,700

Required:

(a) Statement showing adjusted net profit for the years ending 31st December 1948 and 31st December 1949.

(b) Revised statement of earned surplus for the 2 years ended 31st December 1949.

(c) Journal entry or entries required to adjust the accounts.

A SOLUTION

(a)

A CO. LTD.

Adjusted net profit	1948	1949
Net profit reported	$230,000	$102,000
Add:		
Adjustment of accounts receivable control	100	
Adjustment re inventory and accounts payable		20,500
Interest prepaid in 1947	500	
Accrued interest not set up	1,200	3,100
	$231,800	$125,600
Deduct:		
Additional depreciation	9,600	24,300
Christmas bonus to employees	15,300	
Adjustments re inventory and accounts payable	9,100	
Adjustment re bad debts	1,100	4,100
Reduction of inventory to market		60,700
	35,100	89,100
Revised net profit	$196,700	$ 36,500

(b)

Revised statement of earned surplus		
Balance at credit at beginning of year	$202,400	$268,100
Add:		
Net profit for year	196,700	36,500
Adjustment of prior years' depreciation	4,100	
Error in opening inventory	3,700	
	$406,900	$304,600

Deduct:		
Additional income tax re prior years	8,700	
Dividend	100,000	100,000
Loss on sale of securities		11,200
Accounts payable not previously set up	10,300	
Prepaid interest receivable not set up in 1947	500	
To set up reserve for bad debts	19,300	
	138,800	111,200
Balance at end of year	$268,100	$193,400

The amount of $150,000 should be shown separately as Surplus arising from Appraisal of fixed assets.

(c) BOOKS OF THE A CO. LTD.

	Dr.	Cr.
Earned Surplus	$150,000	
Increase in fixed assets resulting from appraisal		$150,000
To set up appraisal surplus as per appraisal of X, Y and Z and per minutes of directors dated		
Earned Surplus	29,800	
Reserve for Depreciation — Buildings		29,800
To record additional depreciation charged resulting from change in company's method of depreciation from percentage of sales to straight line basis.		
Inventory	4,800	
Earned surplus		4,800
To record stock omitted from inventory as per supplementary inventory sheets on file.		
Interest receivable accrued	4,300	
Earned surplus		4,300
To set up accrued interest receivable as at 31st December 1949.		
Earned surplus	16,200	
Reserve for bad debts		16,200
To set up additional amount necessary to provide for estimated loss by bad debts.		

Editor's Note: Some of the points of interest in this question are:

(a) The bankrupt account of $8,300 should be charged against the Reserve for bad debts (not earned surplus).

(b) The interest accrued and prepaid relates to loans due to the company and therefore affects interest revenue, not interest expense.

(c) The journal entries required by part (c) are the journal entries required to correct the accounts as of 31 December 1949 (the date at which the accountant would have to deal with the problem) and not the journal entries in the prior years.

PROBLEM 2

Intermediate Examination, October 1950

Accounting I, Question 2 (10 marks)

On 31st December 1948 the B Co. Ltd. acquired 90% of the outstanding shares of the C Co. Ltd. for $1,500,000. The shares so acquired had a par value of $1,200,000 and the earned surplus as at 31st December 1948 on the C Co. Ltd. books was $200,000.

During the year ended 31st December 1949 the net profits of the C Co. Ltd. were $60,000 and dividends totalling $100,000 were paid.

Required:

(a) Assuming that the B Co. Ltd. records on its books the earnings and dividends of subsidiary companies, what entries would you make in respect of earnings and dividends of the C Co. Ltd. on B Co. Ltd. books?

(b) Assuming that the B Co. Ltd. records on its books only the dividends received from subsidiaries, what entries would you make in respect of dividends received during the year from C Co. Ltd. on B Co. Ltd. books?

(c) What would be the goodwill appearing on the consolidated balance sheet of the B Co. Ltd. as at 31st December 1948 after and as a result of the acquisition of the shares of the C Co. Ltd.?

(d) What would be the amount of the minority interest in C Co. Ltd. appearing on the consolidated balance sheet of the B Co. Ltd. as at 31st December 1949?

A SOLUTION

(a)

BOOKS OF B CO. LTD.

Investment in subsidiary	$ 54,000	
Profit and loss account		$ 54,000
To record B Co. Ltd. equity (90%) in the net profits of C Co. Ltd. for year ended December 31st 1949.		

Cash	90,000	
Investment in subsidiary		90,000
To record dividend received.		

(b)

BOOKS OF B CO. LTD.

Cash	90,000	
Investment in subsidiaries		36,000
Income from investments		54,000
To record dividend received of which $36,000 was paid out of surplus existing at date of acquisition of shares.		

(c)

$120,000. [$1,500,000 — ($1,200,000 + 90% of $200,000)]

(d)

Minority interest

Share capital (of Company C)	$\frac{\$1,200,000}{9}$ =	$133,333	
Surplus (company C)		16,000	$149,333

Editor's Note: A point of interest in this question is that it states that the par value of shares *acquired* — not of the total shares of C Co. Ltd. outstanding — was $1,200,000.

PROBLEM 3

Final Examination, October 1950

Accounting I, Question 1, (12 marks)

The following information has been secured for the purpose of estimating for the year 1950 the machine hour rate of factory service applicable to the machines operating in Department A. The 1950 rate is to be based upon the 1949 results:

(a) The machines occupy one-quarter of the space in Department A.

(b) Cost of rent, insurance, etc. of the factory was $13,536 of which one-sixth was allotted to Department A.

(c) The foreman of Department A was paid $3,384. Half of his time was devoted to the machines.

(d) The heating and lighting cost of Department A amounted to $1,128.

(e) Other expenses, which fluctuate with the productive running hours, amounted to $3,192 for the 6 machines.

(f) The factory works on a 40 hour week but is closed 2 weeks each year for holidays. During the working hours each of the machines is stopped for 120 hours per annum for periodical cleaning and oiling. During 1949, because of an unexpected delay in obtaining raw materials, the machines lost an additional 260 hours each and as a result of a strike of operators the factory closed down for a further 100 hours.

(g) Cost of each machine was $10,000 and its scrap value is estimated at $240. The life of a machine has been estimated at 40,000 running hours.

(h) The estimated repairs over the life of a machine are expected to amount to $800.

(i) The power meter in the department showed that the power used by each machine amounted to 10 units per hour. Power was charged to the department at 2½c per unit.

Required:

Calculate the suitable machine hour rate of factory service applicable to the machines operating in Department A.

A SOLUTION

Number of machine hours per machine:		
40 hours — 50 weeks		2,000
Cleaning and oiling		120
		1,880 hours
Unusual stoppages:		
Delay in raw material	260	
Strike	100	360
Hours worked during the year		1,520 hours

Fixed expenses:				
Rent, insurance etc.				
¼ of 1/6 of $13,536 =	$ 564			
Foreman				
½ of $3,384	1,692			
Heating and lighting	282		$2,538	
Expense per machine =	$ 2,538		$ 423	
	6			
Rate per machine hour	423=			$ .225
	1,880			
Variable expense:				
Other expenses	$ 3,192	$532		
	6			
Rate per hour thereon	532=		.35	
	1,520			
Repairs and depreciation	$10,560			
Rate per hour thereon	10,560		.264	
	40,000			
Power			.25	.864
Total variable and fixed machine hour rate				$1.089

PROBLEM 4

Final Examination, October 1950

Accounting I, Question 3 (10 marks)

The following information re the C Co. Ltd. was compiled for different rates of production:

	50% of normal	80% of normal	Normal Capacity output	120% of normal
Sales (at $4 per unit)	$60,000	$96,000	$120,000	$144,000
Total costs, including costs of goods sold, distribution expenses, etc.				
Variable	30,000	48,000	60,000	72,000
Fixed	40,000	40,000	40,000	40,000
	$(10,000)	$ 8,000	$ 20,000	$ 32,000

Required:

(a) At what percentage of normal capacity output is the break-even point reached?

(b) If it were not for the loss because of idle capacity, would there be any net profit at 50% of normal?

(c) How much of the net profit may be attributed to gain due to intensive use when operations are at 120% of normal capacity output?

(d) When operation is at 50% of normal, would it be wise for the management to contract to produce an additional 5,000 units at a sale price of $3.35 per unit? Explain.

NOTE:—Show calculations to support your answers.

A SOLUTION

(a)

THE C CO. LTD.

	50%	80%	100%	120%
Sales	$60,000	$96,000	$120,000	$144,000
Sales units	15,000	24,000	30,000	36,000
Variable	30,000	48,000	60,000	72,000
Variable per unit	$2.00	$2.00	$2.00	$2.00
Fixed	40,000	40,000	40,000	40,000
Fixed per unit	2.66	1.66	1.33	1.11

Selling price per unit	$4.00
Variable expense per unit	2.00
Differential to cover fixed costs	$2.00 per unit
Fixed costs are	$40,000

Therefore breakeven point is production of 20,000 units or 66 2/3% of normal capacity output.

(b)

Assuming no idle capacity—profit at 50% of capacity

Sales — 15,000 units @ $4		$ 60,000
Variable @ $2 per unit	$ 30,000	
Fixed @ 1.33 per unit	20,000	50,000
Net profit if it were not for loss on idle capacity		$ 10,000

(c)

Sales — 36,000 units @ $4		$144,000
Variable @ $2	72,000	
Fixed @ $1.33	48,000	120,000
Profit		$ 24,000
Gain on intensive use		8,000
Net profit		$ 32,000

(d)

If contracted production would be 20,000 units

Selling price 15,000 @ $4.00		$ 60,000
5,000 @ 3.35		16,750
		$ 76,750
Variable costs @ $2.00 per unit	$ 40,000	
Fixed costs	40,000	80,000
Net loss		$ 3,250
Net loss at 50% of normal		$ 10,000
Therefore loss would be less at added production by		$ 6,750